GOVERNMENT BUDGETING AND EXPENDITURE CONTROLS
Theory and Practice

A. Premchand

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To

Rama

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Prefatory Note

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The views expressed in the book are those of the author and should not be construed as representing the views of the Fund.
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Introduction

The character of budgeting and the tasks of government have changed radically since the turn of the century. Although the traditional protective role of the state has continued, following World War II the tasks relating to reconstruction and development have become increasingly important. Over the years, the growing involvement of the state in the provision of social services and welfare programs, state ownership in industrial, manufacturing, and trading activities, and, more recently, concerns of demand management have added to the burdens of the government in budgeting and financial management.

Traditional studies on governmental budgeting have focused on detailed descriptions of government budgetary and accounting systems and on the working of the legislature and its supportive agencies, such as audit. Stourn's study of the French system, Durell's work on the British parliamentary system, and Willoughby's book on the U.S. system belong to this genre. During the 1920s and 1930s, literature on budgeting dealt at length with the administrative processes, with the relationships between the budgetary and financial agencies and the spending departments, and with issues of autonomy and delegation between the executive and the legislative branches and within the executive branch. The focus of research shifted somewhat during the interwar period, when budgeting began to be analyzed in terms of the economic functions for which it was responsible. Later approaches to the study of budgeting were influenced by the growth of national accounts, emphasizing the importance of formulating budgets within a macroeconomic framework. The adoption of formal development planning implied that greater attention was needed on the measurement of costs and on evolving budget structures that would better reflect the developmental activities. These imposed on budgeting new tasks and burdens that were in due course reflected in the reforms carried out by industrial and developing countries, as well as in the official and academic literature.

Since the 1960s, more efforts were directed toward the implementation of comprehensive budget reforms benefiting from the lessons learned from experience in such implementation. In analyzing the new budgetary issues and the responses of the systems, however, it appears
that each discipline took a rather compartmentalized view of the working of the budgetary and financial institutions. Political science-oriented research studies were primarily drawn from or addressed to conditions in the United States and usually dealt with the political problems of control and strategies adopted in the context of congressional approval of budgets. Later, with the introduction of Planning, Programming, and Budgeting Systems (PPBS), these studies devoted more attention to conflicts between the executive and the legislative branches and the difficulties of obtaining political approval for systems that implied, in some measure, a shift of control from the legislature to the executive. Public administration studies, which hitherto had dwelt largely on the normative aspects of ideal organizations, were devoted to an analysis of the features of PPB systems, their antecedents, their operational implications, and their limitations.

Economists, for their part, concentrated their energies in the early 1950s and 1960s on developing appropriate criteria for the determination of public expenditures that, in practical terms, were limited to new investments on major projects. They achieved a major breakthrough in imparting an allocative bias to budgetary decision making through the PPB systems. These systems, which aimed at achieving allocative efficiency by integrating economic analysis, medium-term financial forecasts, and techniques of appraisal of expenditure with the normal budget cycle, reflected an ideal solution to the economist's concern for the role of government in resource allocation. With the premature "demise" of the system, or its inadequate implementation, however, economists turned their attention from institutional aspects to the continued study of tax policies, tax incidence, and the search for patterns of regularity to explain the determinants of public expenditure. Frequently, their attention is also devoted to the study of subsidies, transfers, growth in current expenditure, and its implications for public saving. By and large, economists as a group appear to have resigned themselves to a self-imposed martyrdom and to have disassociated themselves, during recent years, from the study of budgetary systems. Although, with the advent of public choice as a separate field of inquiry, attention is being devoted to the economics of political issues, the study of systems continues to be neglected.

The tasks of budgeting (and thus of budgeteers) have meanwhile become more complex and seemingly intractable. The concerns of the budgeteer are economic, political, social, and administrative in nature.
His daily tasks constitute a mosaic that includes an element from each of these disciplines. His activity is the central point at which the disciplines merge, providing an empirical art form familiar to practitioners but novel to students. His concern goes beyond an administrative technique or an economic aspect and his contribution to policymaking is expected to provide a financial dimension that reflects economic realities as well as the goals of political leadership. His statesmanship lies not merely in providing solutions to immediate problems but also in a precise anticipation of the likely shape of things to come and in providing for a flexibility in policies. Since no other activity of government touches every member of society as does finance, he is expected to reflect the sensitivity of the common man. He also needs the imagination to convince his colleagues in government on every aspect of policy. He cannot be revolutionary, impulsive, or intuitive; he has to act in a gradual, rational, and, to a large extent, quantitative manner. These qualities demand understanding, patience, vision, courage, leadership, and a certain expertise in the dynamics of government. Obviously, no individual can combine all these elements within himself, but he must recognize that the interplay of the various forces is vital for the survival and effective functioning of the budgetary system.

Ideally, if the financial rules, regulations, and procedures of every government were implemented, there should be little problem in financial management. In practice, however, their implementation in the budget process reveals several problem areas. This book examines these issues that are at the heart of public policymaking. It discusses in detail the economic and administrative aspects of budgeting and their interplay. Formulation of economic policies without recognition of the institutional constraints is an open invitation to failure; emphasis on administrative aspects without recognition of the economic basis and purposes of policy is counterproductive. The chapters of this book delineate the role of each of these aspects of budgeting and their mutual supporting roles, while considering the theories, practices, and problems that arise in regard to them.

The book covers developments in budgeting and expenditure controls in industrial and developing countries, discusses the efficacy of budget reforms that have been introduced, and analyzes successes or failures and the current state of these reforms. Although the economic status of the two groups of countries differs widely, the concerns of
budgetary policy and budgetary management of both the industrial and developing countries are the same. They relate to the utilization of budgets as instruments of national economic management, communicating the resource constraints to spending departments, reducing gaps between planned and actual expenditures, and achieving better control of open-ended transfers. The ramifications of these areas are considered in terms of the policy objectives, areas to be controlled, methods of control, checks and balances of the systems, and related aspects.

The book is divided into three parts. Part I considers the theoretical and practical aspects of budgeting, using a predominantly economic approach. The first chapter, which provides the background for the role and objectives of fiscal policy, is followed by a discussion of the nature of budgeting, determinants of public expenditure, functional aspects of budgeting, measurement of the impact of budget, approaches to decision making, and the problem areas of budgeting. Separate chapters discuss more specifically development planning and budgeting, expenditure planning and forecasting, budgeting for inflation, and short-term aspects of public expenditure adjustment. Part II, which deals with structures, systems, and financial management, is more administrative in its approach. Its four chapters cover budget structures, budget innovations, budget execution and cash management, and government accounting. Part III discusses budgetary relationships between the government and enterprises, and between the central government, and state or local governments. It illustrates the problems of multilevel decision making. Although some of these areas deserve more extensive treatment in their own right (and have indeed been so treated in the literature), the book aims at examining them only from the vantage point of government budgeting and, therefore, must treat some subjects in summary form. No effort is made to analyze the role of audit or to examine the aspects of legislative accountability, for they form independent areas of inquiry.

The gap between theory and practice reveals the shortcomings of both—each in its own way. Similarly, the lack of identification or understanding of the precise nature and magnitude of the problems—or the hesitant reaction, rime-lapsed responses, and associated features—may suggest a degree of pessimism on the future of budgeting and its adequacy. The purpose of the book is not to present alternative systems but to consider the alternatives available and to assess their
relevance. It should lead to greater understanding of budgeting for interested readers and should guide the practitioner toward better budget management.

The gaps in implementation and the practical problems discussed in the text, except where specifically indicated, are drawn from a composite picture of the experiences of industrial and developing countries. Although every effort has been made to provide documentation, it should be noted, however, that the statements are based on direct observation, personal experience, and casual empiricism.

Some terms used in the text have more specific or varying connotations in some countries. General terms are therefore preferred: for example, the terms administrative agencies, departments, spending ministries, and bureaus are used interchangeably. It is to be noted that the institutional features discussed in the text refer to the situation up to and during 1980-81. The principal emphasis is on examination of the broad institutional framework and of its capabilities for implementing fiscal policies.

In the course of writing this book, the author became deeply indebted to many friends and officials. Although the book in its present form was written during a sabbatical leave from the International Monetary Fund, when the author was a Visiting Fellow of Nuffield College and Queen Elizabeth House, Oxford University, some of the material had previously been presented to seminars conducted at the American Society of Public Administration, the Asian Development Institute (Bangkok), the Economic Development Institute (Washington, D.C.), the IMF Institute (Washington, D.C.), the German Foundation for International Development (Berlin), and the International Center for Public Enterprises in Developing Countries (Ljubljana), and had been published in the journals *Economic and Political Weekly, Finance and Development,* and *Public Budgeting & Finance.* Specific parts had also been presented to the First and Second Seminars on Budgeting and Expenditure Control, organized by the International Monetary Fund in Washington during 1980 and 1982. The author is grateful to the seminar participants, who have contributed a great deal to the making of this book. Thanks are also due to the International Monetary Fund for granting sabbatical leave and for providing numerous professional opportunities and challenges. The views expressed in the book are those of the author and should not in any way be attributed to the Fund. Richard Goode, then Director of
the IMF Fiscal Affairs Department, and Vito Tanzi, Director of the Fiscal Affairs Department provided much encouragement. The Wardens of Nuffield College and Queen Elizabeth House kindly made available their facilities, and Lady Hicks, I.M.D. Little, and Maurice Scott at Oxford University were sources of encouragement.

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Part One

BUDGETING
Fiscal Policy
Parameters for Budgeting

"Would you tell me, please, which way I ought to go from here?"
"That depends a good deal on where you want to get to," said the cat.
LEWIS CARROLL, Alice's Adventures in Wonderland

Fiscal policy, which was traditionally concerned with the provision of services by government and the mobilization of resources needed for financing them, has undergone a transformation during the last five decades. It is now on the threshold of further changes. The fiscal machinery, in particular the techniques and procedures of budgeting, is being adjusted to meet the changing requirements of fiscal policy. An understanding of the fiscal policy is essential for gaining proper perspectives on the different aspects of budgeting. Therefore, this chapter is devoted to a consideration of the functions of fiscal policy and of its role in industrial and developing countries, recent issues in the conduct of fiscal policy and their implications for budgeting and expenditure controls.

Fiscal policy consists of the use of taxes, government spending, and public debt operations to influence the economic activities of the community in desired ways and is concerned with the allocation of resources between the public and private sectors and their use for the attainment of stability and growth. Although the effects of fiscal policy are extensive, they are particularly measurable in areas such as employment, price stability, savings and investment, and the balance of payments. Fiscal policy aims at using its three major instruments—taxes, spending, and borrowing—as balancing factors in the development of the economy. The use of the term here is limited because it excludes debt management, which is viewed as an integral part of
BUDGETING

monetary policy. Formulation of fiscal policy presumes the identification and clear recognition of the institutional aspects of government finance, such as tax systems, their incidence and shifting, budget formulation and execution, and financial management. The focus of budgeting is on the attainment of efficiency in the allocation of resources within the public sector and is influenced at each stage by the goals of fiscal policy. As this study aims to analyze the role and functions of budgeting and related expenditure controls, the following discussion on fiscal policy and its changing impact on the scope and operations of budgets excludes consideration of taxes as instruments of fiscal policy.

DEVELOPMENT AND FUNCTIONS OF FISCAL POLICY

The term fiscal policy came into popular use during the Great Depression. Until then, it was used (if at all) to denote a policy that affected the royal or public treasury. The policy itself was an extension of the prudent fiscal behavior expected of an individual for balancing his income and outflows. As Adam Smith put it, “What is prudence in the conduct of every private family can scarcely be folly in that of a great kingdom.” The application of the principle, however, involved a major difference that recognized the larger functions of the state and permitted it to borrow during such emergencies as wars. This approach, which governed the thinking during the eighteenth and nineteenth centuries, was given the most succinct expression by Bastable, who wrote toward the end of the nineteenth century, “Under normal conditions, there ought to be a balance between these two sides . . . of financial activity. Outlay should not exceed income, . . . tax revenue ought to be kept up to the amount required to defray expenses.”

1 Government action can be considered to be purely a fiscal policy matter only when the effect of borrowing is neutral in terms of the availability of money to the private sector. Pure fiscal policy is, however, rare, because any change in revenues and expenditures involves changes in the financing of the budget surplus or deficit and, hence, always has an interface with monetary policy. Management of the debt—particularly, the composition of the instruments, the timing of their issue, and their duration—are aspects more closely associated with monetary policy.

2C. F. Bastable (1903), p. 611.

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down the expedience of estimating for a moderate surplus, by which the possibility of a deficit will be reduced to a minimum.” The guarantee of fiscal prudence lay in aiming at a moderate surplus so as to avoid the possibility of a budget deficit. The constraint of the balanced budget became a key operating factor for politicians and civil servants alike, and any departures from this approach were considered to be journeys toward profligacy that would erode the prosperity of the country and eventually lead to financial ruin. The approaches of budgeting naturally reflected this classic principle and were fairly simple. To put it into operation, a central agency—called finance—with no administrative or spending policies of its own, was organized to review the proposals of the spending departments. It was accepted that finance alone, which was charged with the responsibility for raising revenue needed for meeting expenses and, in a manner, filling up the financial reservoir, should also know the depth of this reservoir and outflows from it. The management of the taxpayers’ contributions could not be left to the mercies of the spending departments, and a finance ministry or treasury was expected to provide a vigilant supervision of the activities of the spending departments. The primary responsibility of the central agency was to economize effectively and promote financial order within the government. The embodiment of the general principle of a balanced budget as the guiding star of the treasury was noted by Durell, who observed “[t]he public and the Parliament should be satisfied that somewhere or other in the government there is a guarantee for financial order; that there is some authority which will watch the progress of expenditure, the obligations which the different departments are incurring and will give timely warning if that expenditure or those obligations are either out-running the revenue provided for the year or engaging the nation too deeply in future years.”

Budgetary scrutiny and review therefore concentrated on the legality, propriety, economy, and efficiency of expenditures. Macroeconomic functions, as they have come to be subsequently known, were not a part of the lexicon of the operating budget officials; their approach was dominated by accounting and administrative considerations. From any point of view, it was a simpler world then.

This situation was, however, reversed in the 1930s when fiscal

policy came into being in its own right. The onslaught of the Depression in 1929 raised a number of leading issues on the role and policies of government budgets. Initially, efforts were mainly directed toward combating the Depression, which had already gathered momentum, by providing money at lower costs in order to encourage investment. However, there was no increase in investment, as businessmen were reluctant to borrow and invest at a time when the profit outlook was dim. Money became cheap but proved ineffective as an instrument for inducing investment in the private sector. Households were not spending enough, nor were governments. The situation prompted the financial policymakers to envisage government deficits to reactivate the economy and to reduce the levels of unemployment. However, there was also the official view, reflecting in a way the continuing influence of the balanced budget approaches, that government expenditures financed by borrowing did not necessarily increase employment and could be construed as merely diverting resources that would have been otherwise invested by the private sector. It was in this context that the liberating ideas of John Maynard Keynes, and his advocacy of deficit spending, came to be considered.

Keynesian contributions have influenced economics in more than one sphere, and they may broadly be examined in terms of economic theory, as policy prescriptions to deal with unemployment and as a philosophy that believed in government intervention for managing the economy to minimize unemployment. Keynes pointed out that the fundamental cause of the Depression was the lack of spending. The decision to save in the household sector did not necessarily lead to a decision to invest, and the government therefore had to step up its expenditures in order to "prime the pump" of the economy. It was recognized that public borrowing absorbed private saving, but such borrowing contributed to greater economic activity, while money retained in the private sector would have more likely contributed to greater unemployment than to increased private investment. In Keynesian terms, budget deficits were viewed as positive instruments to shore up aggregate income to stimulate all sectors to spend more. Keynesian economics freed the thinking of the treasury from the narrow concept of balancing the budget to the wider role of balancing the whole economy. The Keynesian view of the state implied that it had both an obligation and an ability to control any instability in the economy and to restore functioning order.
The acceptance of these ideas ushered in a fiscal revolution. Budgeting ceased to be a mere tool of accounting and acquired greater dimensions. The increase in expenditure that accompanied the more active role assumed by the state brought with it a transformation in the size of the budget, since fiscal policy could be meaningful only when public expenditure comprised a substantial portion of the gross national product (GNP). Budgets have come to be linked with management of the economy, in turn bringing a greater consideration of the effects of expenditures on the economy. Past were the days when expenditures were considered merely in terms of type and the authorities responsible for incurring them. Now, it is also envisaged in terms of the multiplier effects of expenditures on incomes, consumption, saving, and investment. As most expenditures had come to be financed by borrowing from the public, it also became necessary to consider the productive capacity of the programs being financed in order to ensure future financial viability. The budgetary process, in due course, became more important, because here the administrative, accounting, economic, and financial objectives interfaced and collectively produced a coherent fiscal policy.

The spread of Keynesian economics did not help much in easing the problems emerging from the Depression. The Depression itself came to an end with the beginning of the increased expenditures for the preparation and actual conduct of World War II. Also, there was a substantial growth in expenditures, reflecting the expansion in the social functions of the state, and the operations of government had begun to have a magnified effect on the level of the overall demand. Increases in spending raised the level of demand, while increases in taxation (undertaken to finance the increased expenditures) reduced it. Thus, budget surpluses and deficits had different effects. Fiscal policy, which was viewed during the Depression as unidirectional, became two-dimensional as the instruments of taxation, expenditure, and borrowing could be used to control aggregate demand. Fiscal policy extended beyond its definition as a series of measures intended to provide compensatory action to fluctuations in private spending in the context of a trade cycle to the achievement of stabilization in the economy through its influence on aggregate demand. It thus had to contend with both recession and inflation.

The balance between aggregate demand and supply in the economy, which is the key for stabilization, is achieved through fiscal policy. An
increase in the flow of money to the government, other things remaining equal, will lower aggregate demand while a decrease will stimulate it. The formulation of policies designed to achieve these subtle changes in the economy requires that there is, as a prerequisite, a detailed understanding of the linkages in the economy, the lags with which taxes and expenditures have an effect, and the magnitude of such effects. The determination of an appropriate level of aggregate demand is a formidable and complex task. In somewhat general terms, an appropriate level of demand is one that would ensure a reasonable utilization of productive capacity (and thus employment) while maintaining some price stability and sustaining an economy conducive to longer-term growth and an acceptable balance of payments position. These wide-ranging concerns cannot, however, be pursued, much less established, by fiscal policy alone and require active coordination with monetary, income, and balance of payments policies. More significant, however, is the fact that these objectives are not always reconcilable. Policies do not come in neat packages with conflicts fully resolved. Conflicts among the objectives are real, and the adoption of any solution involves political repercussions. Such political fallout is only natural, because the real world is a world of politics. The level of aggregate demand is not immutable, and the impact of the budget depends not on the internal consistency of its accounts but on the nature and state of the economy. If the economy is characterized by inflation, the formulation of a balanced budget is unlikely to be of any use. Its contribution would be limited to the negative aspect of not adding any more inflationary pressures of its own. The budget will have to take into account the trends and magnitudes of consumer expenditures and use appropriate fiscal instruments. As the nature of the economy changes both in the medium term and short term, or even during the fiscal year, it is obligatory for the government to adjust its policies and to switch horses in midstream, if so required. Pursuit of stabilization as a goal of fiscal policy thus involves budgetary planning and a continual assessment of the dynamics of the working and impact of the budget. Traditional budgeting involved a reckoning for the next year with a degree of certainty in the economy. The future was obviously more certain when the only function of fiscal policy was to allocate funds for the limited range of services provided by government. As expenditures increased and as they became dependent not merely on the supply constraints but on the general economic climate,
the uncertainty involved in budgeting also increased. This aspect imposed additional burdens on budgeting.

Management of aggregate demand is a short-term function of fiscal policy. Stability in a stagnant economy is of no consequence. Fiscal policy, therefore, has to aim at stability in a growing economy. Emphasis on growth, as discussed further on, has different implications in industrial and developing countries. In the former, the aim of fiscal policy is to ensure the full utilization of the capacity and productive use of the resources, while in the latter, fiscal policy has the aim of increasing the flow of savings to the government sector for financing development expenditure and for providing related infrastructure that in turn generates more growth. In the industrial countries, greater attention is also given to fiscal policy for maintaining full employment and minimizing the impact of cyclical forces. Fiscal policy is used, on the one hand, to stimulate demand and thus ensure a marker for the goods and services produced, and on the other hand, to encourage the appropriate use of labor and capital to increase employment. Another use of policy is to make capital assets more expensive relative to labor by levying taxes on the use of capital-intensive technology and giving wage subsidies. The important consideration in all this, however, is the compatibility of these goals with that of economic stability.

Yet another role of fiscal policy is to minimize the adverse distributional impact of government policies. Traditionally, distribution has been analyzed in terms of factor shares (wages and capital income). However, in due course and particularly in the context of maintaining aggregate demand and higher levels of employment, it became apparent that while wages and capital income might be adequate at a national level, regional and sectoral disparities would persist and, in some cases, would even widen further. Therefore, intense pressures arose to reduce the regional disparities in racially diversified countries and the inequalities between rural and urban sectors. These pressures became a constant feature of current political discussion. The need for greater attention to these areas was self-evident in a context characterized by growing poverty in the developing societies and by lack of evidence that the process of economic development had had the desired impact on the lower classes. Another major factor was the recognition that the political realities would not permit a further widening of the distribution

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patterns.  Although there is less convincing evidence that fiscal policy alone would be able to reduce the inequalities stemming from the existing operations of government—much less reduce the cumulative inequalities—it is clear, however, that in conjunction with other social reforms, it has considerable potential for this purpose.

Fiscal policy is so wide-ranging that selection of a combination of differing objectives is both complex and controversial. The impact of these objectives on budgeting is threefold. First, budgeting involves the identification and measurement of the impact of the budgetary operations on the economy, and of the economy on the budget, and the relationship of these operations to the overall objectives. Second, the objectives of fiscal policy can be attained through the instruments of taxes, expenditures, and, to an extent, the provision of credit. The effects of these instruments are not identical, and one task of budgeting is to ascertain the effects of each and to arrange the three instruments so that they collectively serve the purpose. Third, the objectives are served by direct government operations, through the activities of other levels of government, notably the state and local governments, and through the public enterprises at each level. Fiscal policy at a macroeconomic level requires close coordination among all three levels in all phases of the budgetary process.

**FORMULATION OF FISCAL POLICY**

Fiscal policy has acquired, over the years, the above-noted wide range of functions. But the actual policy at any given stage involves the transmutation of attitudes and approaches into specific responses to particular challenges that are recognized in the functioning of the

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4 Robert S. McNamara, former President of the World Bank, noted in 1972 in his opening address to the Boards of Governors of the World Bank and the International Monetary Fund, "[w]hen the highly privileged are few and the desperately poor are many—and when the gap between them is worsening rather than improving—it is only a question of time before a decisive choice must be made between the political costs of reform and the political risks of rebellion." He also provided a graphic description of poverty in his opening address to the same gathering in 1980. "Absolute poverty . . .," he stated, "is a condition of life so limited by malnutrition, illiteracy, disease, high infant mortality, and low life expectancy as to be beneath any rational definition of human decency." Poverty is not only a feature of developing countries, it is also found in industrial countries. Differences are in the nature, extent, and profile of poverty.
If insufficient weight is given to practical factors, policy formulation becomes a ritualistic exercise and implies an uncertain contact with reality. Thus, the very first task is the development of underlying aggregates that characterize the economy so that their nature and magnitude can be perceived and assessed, to the extent possible, in quantitative terms, by planners and politicians alike. While different perceptions are inevitable, since each decision maker is influenced either explicitly or implicitly by his hidden or revealed social preferences, the aggregates and their analysis permit a framework within which the objectives and the means available for reaching them can be considered. Not all objectives can or need be pursued with the same vigor. Some are obviously more important than others; some are of a short-term nature, while a few others would involve a continued allocation of resources over a sustained period. Some are better achieved through the encouragement of the private sector, while a few tasks can be undertaken only in the public sector. The political sensitivity of some proposals reduces their attractiveness.

The fiscal policy to be pursued in any year therefore involves a reckoning of an infinite number of factors; conscious and deliberate planning is needed to reconcile the objectives into a workable compromise. The formulation of fiscal policy should take into consideration the range of the instruments and their relative efficacy in performing given tasks. Much is dependent on the analytical capability of the administrative system and the skill and foresight shown by the administrators.

The second major task relates to the determination of the resources to be acquired by government from the private sector and to the maintenance of balance between public and private sectors. Resources needed by government are partly determined by its expenditures and partly by its stabilization and distributional goals. These, however, are not independent factors but are drawn from the perceptions of those who are entrusted with the political responsibility of administering the country. The balance between public and private sectors is primarily a political choice and is influenced by several considerations. The process of making this choice is complex and has always been controversial. The typical textbook examples of a pure market economy with private enterprises or of totally centrally planned economies with state enterprises are rarely found in the real world. In practice, therefore, the issue is one of determining the relative boundaries and the duration for
which such lines of demarcation should remain in force. As noted earlier, the role of the state had come to be dominant in an economic sense, and its functioning as a stabilizing agent is deeply rooted in Keynesian economics, in the belief that the government has an important role in the management of the economy.

The third aspect of fiscal policy formulation is related to the consideration of the instruments appropriate to attain the specified objectives. Viewed in terms of government expenditures, the objectives discussed in the preceding section, their determinants, and the instruments available are illustrated in Table 1. Collectively, the choice of the relevant instruments and the allocation of necessary funds form the heart of budgeting. The significant change that budgeting has undergone—with the transformation of fiscal policy from the goal of balanced budgets to the goal of balance in the economy, to the promotion of growth, and to lessening distributional inequalities—is in the use of strategic economic planning, in addition to the traditional functions of financial and managerial control. The new role of budgeting consists of the determination of the kind and level of activities that are sought to be carried out by governments.

**APPLICATION OF FISCAL POLICY: INDUSTRIAL AND DEVELOPING COUNTRIES**

What is the role and applicability of fiscal policy in the industrial and developing countries? How is it used? What are its limitations? These are some of the issues that require examination, if only because they provide the relevant parameters within which the system of budgeting functions. Economists have, over the last three decades, used several terms to indicate the broad economic groups of countries. In order to categorize the nonindustrial countries for determining the relevance of the new fiscal policy approaches, newly emerging nations were described as "undeveloped," "underdeveloped," "less developed," or "developing" countries. In the recent literature on budgeting, a distinction is made between "poor" and "rich" countries. 5 For purposes of analysis here, however, the distinction between industrial and

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5See Naomi Caiden and Aaron Wildavsky (1974). In terms of the authors' approach, countries that have a per capita income of less than $900 per annum, low levels of resource mobilization, low accountability for expenditures, and weak
developing countries is used. It should be noted that the category "developing countries" covers a wide variety of economic systems at different levels of economic development. Although dichotomous approaches or broad groupings have inherent limitations, they are utilized here in discussing convenient benchmarks for considering the relevance of fiscal policy.

In the early days of the development of fiscal policy, when it was still used to prevent a depression, it was assumed that the same technique could be used in both industrial and developing countries. But this assumption proved to be incorrect, in view of the differences in the relative levels of development. Fiscal policy in industrial countries was first identified with reducing unemployment by stimulating demand through deficit spending. During periods of weak demand, industrial countries have large pools of unemployed productive resources, including underutilized capital equipment and managerial skills, and fiscal policy can minimize the cyclical impact through the maintenance of aggregate demand. The leading cause of business cycles in these economies is the fluctuation in demand, and once the pump is primed through public sector spending, the underutilized resources can be rapidly put back to use for increasing production. The situation is different in the developing countries, where unemployment is chronic and reflects structural bottlenecks of the economy rather than those that are cyclical in nature. In the developing countries, injection of increased purchasing power, as is the practice in industrial countries, tends to work itself out through increased imports and increases in prices rather than leading to increased production. It is primarily for this reason that fiscal policy is used in developing countries as an integral part of development plans, with the aim of making appropriate structural adjustments in the economy. Achievement of growth is necessarily a long-term task,

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administrative systems are to be considered as poor. Empirical verification of these criteria reveals that there are at least 66 countries with less than the specified per capita levels but not all of them are poor in the budgetary sense for at least 11 of them had budget surpluses for a few years—some of them being oil producing countries. Even from the resource mobilization point of view, some of them have tax ratios of more than 20 percent of GNP. It appears that equating material poverty with poverty in budget systems is not warranted. Economic and financial constraints operate in all countries, including the rich ones.

Table 1. Public Expenditure Objectives and Instruments

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Determinants of Objectives</th>
<th>Expenditure Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provision for social wants</td>
<td>Sociopolitical approaches</td>
<td>Consumption expenditures incurred in the provision of public goods and services; investment outlays on the production of goods; and provision of general, social, and economic services</td>
</tr>
<tr>
<td>Optimal growth</td>
<td>Socioeconomic imperatives</td>
<td>Investment expenditures; other outlays on the provision of infrastructure facilities; and loans to private sector</td>
</tr>
<tr>
<td>Employment</td>
<td>Socioeconomic imperatives</td>
<td>Investment in labor-intensive industries; subsidies; and related fiscal incentives</td>
</tr>
<tr>
<td>Stabilization or demand management</td>
<td>Economic factors</td>
<td>Reductions or increases in expenditures; changes in the composition of expenditures and methods of financing budget surpluses and deficits</td>
</tr>
<tr>
<td>Distribution of income</td>
<td>Sociopolitical approaches</td>
<td></td>
</tr>
<tr>
<td>(i) among people</td>
<td></td>
<td>Transfer payments; direct and indirect subsidies; provision of goods and services free to specified income groups of the community</td>
</tr>
<tr>
<td>(ii) among regions</td>
<td></td>
<td>Investment in less developed regions; greater subsidies and grants</td>
</tr>
</tbody>
</table>

Note: In a way, all the objectives and instruments listed above are related to each other. But some objectives are more closely related to some instruments and this aspect is illustrated above.

and more reliance is placed on fiscal policy in developing countries because of the features associated with the working of the monetary policy. Lack of financial markets, or relatively well developed ones, and the existence of large nonmonetized sectors in the economy have tended to reduce the efficiency of monetary instruments, shifting the major burden of adjustment to fiscal policy. Also, the dominant role
assigned to public sector operations in the development process necessitates greater reliance on fiscal policy.

Fiscal policy is also used in developing countries to counteract inflationary pressures. Fluctuations in developing economies occur primarily because of variations in agricultural yields and their prices. An increase in the export prices of primary commodities will bring with it increases in income—and in turn increases in imports and in prices, reflecting the expansionary influences. Fiscal policy may then be directed to mopping up the increases in real income and to diverting for use in financing economic development. A variation of this theme occurs in oil exporting countries. Increased incomes emerging in oil producing countries from oil price increases in 1973 contributed to enormous inflationary pressures there, as the absorptive capacity of the economy was limited and as the increased revenues of the government budget were spent on the salaries of government employees and others. Consequently, the oil exporting countries were forced to undertake major austerity programs and expenditure adjustments in their budgets to contain the inflationary impulses generated in the process of utilizing the suddenly stepped-up oil revenues. In primary producing countries, a drop in the export prices is mitigated through the removal of the taxes levied when prices were high or through the pursuit of an expansive fiscal policy when foreign reserves or external credit are available. This is not to suggest, however, that adjustment in either direction is easy or is without problems, but it is illustrative of the two-way usage of fiscal policy during the short term.

The role of fiscal policy in the long run in developing economies is more positive, in that it seeks to reflect the aspirations of all developing countries. Emphasis on the expansion of productive capacity, on large expenditures for development purposes, on projects that are more viable from the point of view of social return than financial return, and on the attainment of a more equitable distribution of income has become a part of the accepted development strategy of these countries. Fiscal policy, in this context, is geared to the mobilization of revenue resources, to their allocation among competing priorities, and to ensuring that the broad directions of the movements in the economy are in conformity with national aspirations. Particular emphasis is laid on the financing of the budget in such a way that no new inflationary pressures are generated. Financing the budget deficits has been a matter of considerable debate ever since
development planning was formally organized. It is contended that the amount of noninflationary finance in developing countries available for development is generally limited and that, therefore, resort to deficit financing is inevitable. The problem, however, is that if such deficit financing is undertaken without regard to its effect on the money supply and on the availability of resources, it will inevitably lead to inflation and hamper the achievement of the plan. This does not necessarily mean that a balanced budget should be pursued for its own sake. The more practical budgetary problem is to determine how much deficit financing is proper within the envisaged policy framework and at what point it becomes excessive. It is, therefore, a matter that needs to be decided, not with reference to doctrinaire considerations but on a more pragmatic basis in the light of the assessment of the potential of the economy. The view has been advanced, however, that, beyond a point, inflation is the only practical way of transferring command over resources to the public sector; before it reaches that point, it is helpful in minimizing the levels of unemployment and providing a moderate basis for growth in the economy, and as an implicit tax it offers revenue to the government. The tenability of these approaches, as experience suggests, is more than suspect. Inflation is fairly inefficient as a tax, and as a source of financing plans for growth it can be sustained only as long as the net returns from government investment are very high.

The role of expenditures in fiscal policy is partly dependent, as noted earlier, on their overall ratio to GNP and partly on their functional and economic characteristics. Government expenditures can be divided for analytical convenience into those for (a) traditional public goods and merit wants (defense, education, etc.); (b) direct trading and industrial activities of governments; (c) transfers to productive sectors (e.g., industries, agriculture); and (d) transfers to households and individuals. Admittedly, each is dependent on the political perceptions of the state and on the reliance placed on the market system. For purposes of comparison, however (although it should be recognized that international comparisons have limitations), a profile of government expenditures in selected industrial and developing countries is provided in Table 2. It appears that, reflecting the general emphasis on expenditures for development, countries in the developing world spend more on economic services, ranging broadly from a fifth to a third of total expenditures, while the

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### Table 2. Profile of Government Expenditures in Selected Countries

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<tr>
<th>Country</th>
<th>Fiscal Year</th>
<th>Defense</th>
<th>Education, housing, health, and community services</th>
<th>Economic services</th>
<th>Subsidies and current transfers</th>
<th>Capital transfer</th>
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1 A dash indicates data are not available for the year shown; all figures are shown as percentages of total expenditure of the central government and have been rounded.

corresponding outlay in industrial countries is relatively minor. Defense expenditures do not lend themselves to any clear conclusion, owing to the cost-sharing arrangements of alliances and to the geopolitical forces at work. Outlays on education and health tend to be higher in developing countries, in turn reflecting the direct involve-
ment of the state in the provision of social services. Although the expenditure data shown in Table 2 do not show the needed detail, it appears that expenditures on trading and industrial activities tend to be higher in developing countries in view of the role of the public sector in economic development. An important distinguishing feature is that, in industrial countries and some developing countries in the Western Hemisphere, a greater share is claimed by transfers to households and individuals, reflecting the widespread prevalence of social security systems. These transfers constitute more than half the expenditures in industrial countries and have given rise to problems in the formulation of fiscal policies because they have shown a persistent tendency to increase and therefore have ceased to be of much value as a countercyclical measure.

**Working of Fiscal Policy**

Since the end of World War II, there has been a phenomenal growth in public expenditures throughout the world. During the initial period, the causes of growth in the relative magnitudes of expenditures were primarily social and political rather than economic in character. The spread of democracy imposed new obligations. The more democratic a country’s political system, the greater was the incentive for the leadership to provide services that would satisfy the wishes of the community. Empirical surveys of these expenditure increases have not paid sufficient attention to the policy factors. Democratic goals of reaching a wider section of the community have contributed to the adoption of income maintenance and related programs to help the vulnerable and socially disadvantaged classes of people. Social insurance programs, which were introduced in the west European countries at the turn of the century, and which reflected the complex relationships between the growth of labor unions and the prevailing ideologies, were extended further. There was also an expansion in

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7 Data shown in Table 2 do not fully capture this factor, as education and health are generally within the jurisdiction of state and local governments, whose expenditures are not included here.

8 Subsidies and current transfers shown in Table 2 comprise a broad category that includes several types of transfers, including those to enterprises and other levels of government. The statements on social security are based on other data not shown here.
social benefits. The social security system was introduced in the United States much later but the benefits gradually came close to European levels. The base of the public education system was first broadened in America and soon emulated by European countries. Europe showed greater commitment than the United States at the government level in providing housing and improved medical facilities, leading to the concept of a welfare state that came to dominate the planning—and, in fact, became the central theme—in developing countries. Increases in expenditures reflected the changes in the multiple roles of government as consumer, producer, distributor of income, employer, and investor. The new government forms and the scope of their operations changed so much that they no longer conformed (if they ever did conform) to the textbook models.

A number of economic factors also contributed to rapid increases in public expenditure. A statistical survey of the factors and their relative importance is, however, outside the scope of this study. Broadly, the external variables that have had a decisive influence on budgetary magnitudes include (1) the growth and change in the age structure of the population and (2) the income elasticity of demand, which implies that the demand for public services tended to increase with rising individual incomes. In industrial countries some growth in expenditures is also attributable to the availability of greater tax revenues during the initial phase of inflation. These revenues permitted expenditure commitments that would presumably not have been made otherwise. On the supply side, the working of the relative price effect (which implies that prices paid by the public sector have risen faster than inflation), the indexing of certain kinds of benefits, and greater outlays following the sharp rise in oil prices have all added to the growth of public expenditure. These factors have admittedly been uneven in their incidence, as is reflected in the varying rates of growth and in the specific components of expenditures (such as transfer payments, consumption, and capital formation) among countries. Although there is no single scientific theory that can fully explain the growth in public expenditure, it is clear, however, that the social

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9For such surveys, see Organization for Economic Cooperation and Development (1978); Thomas E. Borcherding (1977); Richard M. Bird (1979); and Morris Beck (1979), pp. 313–56. These surveys deal only with the growth of public expenditure in industrial countries.
forces which molded the form of government—and the economic forces operating through the political and organizational processes—have contributed to a situation in which expenditure increases have been continuous and have come to claim an increasing share of GNP.

The financing of the growth in expenditures made obligatory further efforts toward raising more revenue. Countries in both the industrial and developing world have frequently adjusted their tax rates, and the overall tax rates have increased over time. In some countries, the rate of increase in taxes was more than the rate of growth in GNP, but this was necessary for financing the expenditure requirements. However, as revenues lagged behind expenditures, budget deficits became larger in some countries. Table 3 provides selective data on the state of public finance during 1950–75 for 7 industrial and 15 developing countries. It should be noted, however, that these data refer only to the budgetary flows and do not take into account off-budget spending and borrowing. Also, the coverage of the budget in some countries has changed from time to time, reflecting the decentralization efforts to pass on more revenue and expenditure responsibilities to the state and local governments. The data reveal that industrial countries generally had budget surpluses in 1950, and where there were deficits, the magnitude was small. The situation did not radically change throughout the decade and, except for the Federal Republic of Germany and the United Kingdom, the others had surpluses. By 1965 the picture was one of a frightening uniformity of deficits. For purposes of fiscal policy, however, the budgetary magnitudes are best seen, not in absolute terms but as percentages of gross domestic product (GDP). Analysis of the budgetary data in terms of GDP suggests that the United Kingdom, which had a surplus in 1950 of about 2.6 percent, had a deficit of about 8 percent of GDP in 1975. The trend in the developing countries, as shown in Table 3, with the exception of Burma and Zambia, has been one of steadily increasing budget deficits. Steep acceleration in the growth of budget deficits is particularly noteworthy in Jamaica (from 1 percent in 1960 to 8 percent in 1975), Pakistan (from 11 percent to 23 percent), the Philippines (15 percent to 19 percent), and Tanzania (whose deficit increased in the five years 1970–75 from 4 percent to 10 percent of GDP). Zambia, which had budget surpluses in 1965 and 1970, incurred a budget deficit by 1975 that was equivalent to a fifth of its GDP.
The financing of budget deficits could, in theory, be done in one of three ways: (a) by issuing more money, (b) by borrowing from the public or from abroad, and (c) through the balanced budget multiplier mechanism by maintaining the budget deficit constant and by financing the increase in expenditures through increased taxation. The last technique did not have much practical impact, however, as the additional revenues were less than the increases in expenditures. Reflecting their structural differences, industrial countries showed greater reliance on borrowing from the public, while the developing world took the path of credit expansion. The high budget deficits financed by borrowing from the domestic banking system contributed to excess demand and rising prices at home which spilled over to imports. As costs and prices rose relative to foreign prices, export and import sectors contracted and the balance of payments deteriorated.

The role of fiscal policy in the above situations is to aim at stabilization of the economy through measures to counteract the negative influences and restore better economic conditions. Stabilization policies emphasize the need for corrections in the government budget by limitations on credit to government, acquisition of new debt, and mobilization of additional budgetary resources from increased revenues or reduced expenditures. The choice of policy instruments is primarily influenced by the identification of the precise causes of deterioration and the likely effects of different policy instruments. Such stabilization-oriented fiscal policies were broadly followed during the 1950s, 1960s, and 1970s. During this three-decade period, conscious efforts were made to manage aggregate demand and the economy by short-term adjustments in fiscal policies in conjunction with other policies. If, however, the effects of these policies are seen in terms of the size of the budget deficits during 1975 and thereafter, it might appear that the stabilization policies did not have the desired effect. Recent analysis of international experience with stabilization suggests that it is more of an art than a science and that both policy and institutional factors can and do stand in the way of appropriate management of the economy.  

At a policy level, fiscal instruments were used frequently to fight...
Table 3. Selected Countries: Public Finance, Selected Years, 1950–75

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<tr>
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*Data are in countries' respective currencies: revenues include grants received. Data are not consistent for the period and have not been adjusted for changes in the scope and coverage of the government budget. Data relate to central governments only.

Legend: R = Revenues
E = Expenditures
D = Deficit. Surplus is indicated by a plus sign.
recessions, with the short-term emphasis on growth and employment objectives. Although taxes were to be imposed to reduce budget deficits and to reduce the inflationary pressures generated in the process, their mobilization was a problem in view of public resistance and related political costs. Reduction in expenditures posed even more complex political dilemmas, and there was a perceptible reluctance to tackle the problem. This was sought to be compensated for to a certain extent by limitations on the expansion of credit and through incomes policies aimed at restraining wage increases. These approaches were not followed with any consistency, however, and frequently restrictive fiscal policies were followed by inflationary policies for creating employment and promoting growth to repair the political damage done. These periodic swings only created new problems. Since the reversal in policies took place too swiftly, it appeared that the fiscal restraint adopted for controlling inflation had little effect on it and actually worsened unemployment and investment. Conversely, the fiscal stimulus thought necessary for reducing unemployment exacerbated inflation and had an uncertain impact on growth and investment. The available evidence suggests that the reliance placed on fiscal policies for managing the economy was in part based on the success that such policies had in the early 1950s and 1960s—success that is attributable to the relatively stable growth rates of the period, coupled with growth performance. When these conditions changed, the success of the stabilization policies became doubtful. The policies were often too ambitious and measures were put into effect too late. At the institutional level, policies were formulated on faulty economic forecasts and with insufficient recognition of the time lags with which fiscal policies work. In sum, the efficacy of fiscal policy for managing the economy in the short term became seriously doubted by the mid-1970s.\footnote{The futility of the short-term efforts was eloquently expressed by the British Prime Minister James Callaghan in 1976 in these terms: "We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists, insofar as it ever did exist, it worked by injecting inflation into the economy. And each time that happened the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last twenty years," address to the Annual Labour Party Conference, 1976.}

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ISSUES

The trends shown in Table 3 for 1970–75 have continued since then, with a few minor exceptions, as a global phenomenon. The persistence of the growth in expenditures, increasing deficits, and difficulties in raising resources have given rise to serious questions on the direction of fiscal policy and on the institutional adequacy of the budget machinery for controlling expenditures. The issues reflect, as they inevitably would, the economic and political convictions of those who espouse them. Some of the points mentioned below are associated with the monetarist school, some with the public interest school of public expenditure, some with those who belong to neither school but have profound views on the current issues faced by society, and some reflect the analysis of fiscal practitioners. For convenience sake, they are examined in terms of those relating to taxes, expenditures, and the financing of the budget deficits.¹²

The increase in taxation, which, it is contended, had become necessary following the expenditure growth, had disincentive effects throughout the economy by holding back the growth of output. Double-digit inflation magnified an already adverse tax treatment of income from capital, eroding the incentives to save and increasing the financial costs of investment. Moreover, increases in indirect taxation contributed to increases in retail price indices, which, apart from their effects on wage negotiations, have also made exports uncompetitive and unrewarding. The tax burden had a tendency (although this was not always proven) to confer a premium on nonmarket activities (barter and the underground cash economy or leisure and public welfare) and to increase the attractiveness of less-taxed work. More significantly, higher taxation encouraged the adoption of evasive strategies to minimize taxes by a host of activities that lacked any redeeming social value.

As for public expenditures, movement of social assistance payments from discretionary to entitlement programs had, in addition to contributing to problems of budgetary control, tended to have adverse effects on incentives to production. As a logical extension of the

¹²For some typical views in this regard, see James Buchanan and Richard E. Wagner (1978), pp. 1–8; Richard E. Wagner and Robert D. Tollison (1980). In respect of the debate in the United Kingdom, see P. M. Jackson (1980), pp. 66–82.
growth of this category of expenditures, it was implied that, as these payments became durable and came to be an inseparable part of the community's expectations, the possibility of restoring incentives through tax cuts also became too remote to be practicable. As the burdens of inflation increased and as the competitive prospects of domestic industries became dim, governments resorted to the provision of subsidies for private enterprises. Subsidies of this type proved "a certain recipe, not for growth without inflation, but for inflation without growth." Other subsidies intended for households and individuals lacked specificity and tended to treat all income groups alike. More significantly, in the general concern with stabilization, considerations of allocative efficiency, as well as the attack on poverty, were relegated to the background.\textsuperscript{14}

The financing of government budget deficits by printing more money was not followed by an expansion in output, and the feasibility of such a policy was questioned by some economists from the early 1950s. The second approach—financing the budget by borrowing from the public—implied a steady increase in the supply of government bonds. In order to improve their attractiveness for being held on a continuing basis by the public, these bonds were offered at a low price, thus pushing up interest rates. The increased interest rates had the effect of discouraging the issue of private bonds, private investment, and private spending, all of which are interest elastic. In turn, this contributed to a financial "crowding out" of the private sector. Thus, fiscal policy, which in the Keynesian framework would increase incomes through deficit spending and thereby encourage private investment, would, if the financial crowding out is empirically valid, have the opposite effect of reducing private investment. The long-term implications of these fiscal policies were different from the short-term expectations, and this gave rise to a contradiction in Keynesian economics. More important, a view developed that the

\textsuperscript{13}Organization for Economic Cooperation and Development (1977), para. 343.

\textsuperscript{14}Robert S. McNamara described the situation thus, "The argument will be that poverty is a long-term problem and that the current account deficits are a short-term emergency: that poverty can wait, but that deficits can't." He added, "Sustaining the attack on poverty is not an economic luxury—something affordable when times are easy, and superfluous when times become troublesome," opening address to the Board of Governors of the World Bank and the International Monetary Fund, September 1980.
above-mentioned problems might not arise if the government's policy was merely anticyclical rather than conjunctural, so that deficit was followed by surplus in a reliable averaging process. Associated with this view was the contention that enlarged public sectors reduce individual freedoms. The debilitating effects of governmental policies are not necessarily confined, in this view, to fiscal policies only, but are inherent in the massive growth of governmental regulations on individual activities.

The above limitations of fiscal policy obviously vary from country to country and are dependent, to a large extent, on the actual pattern of financing the budget. Nor should it follow that these limitations are accepted by all. Some consider that, over the years, there has been a growing acceptance of the levels of taxation by the taxpaying public, that the public has tended to consider national debt, not with alarm and apprehension but as a reasonably good monetary instrument for long-term and short-term investments, and that inflationary financing has its purpose. It is not the intention here, however, to enter into a discussion of the relative merits of the opposing viewpoints nor to establish the validity of one over another but merely to illustrate the hiatus that fiscal policy reached by the end of the decade of the 1970s. All economists accepted the growth in public expenditure; what some disputed was whether it necessarily implied inadequate use of the resources acquired from the private sector and whether such acquisition had become more destabilizing by fueling inflation by higher taxes and interest rates. The conflicts in Keynesian economics between the short-term and long-term uses of its prescriptions and its overall inability to contain the rising expenditures came to be viewed with concern, and the attraction of this theory suffered serious damage. If the underconsumption theories in the early 1930s and the recognized failures of the market system to provide employment and stability brought greater intervention by government, the failure of the administrative state to stabilize the economy brought back, as will be shown further on, the argument against state intervention and balanced budgets as the only effective remedy for controlling public expenditures. For good or bad, the policy option at the beginning of the decade of the 1980s was viewed as limited to stabilizing the levels

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15 The institutional implications of these issues for budgeting are considered in the following chapters.
of public spending for the time being. This should not, however, be considered, given the diversity in fiscal situations, as a general case against public expenditure as such. Indeed, there are countries and situations where there are clear needs for increasing public investment, for improved provision of collective goods, and greater attention to redistribution programs. Failure to do so could lead to welfare losses. The crucial question then, as it always has been, is how to provide goods and services and how they are to be financed in a manner that assures economic stability, while at the same time retaining the requisite resources in the hands of the community and providing an incentive structure that will promote growth in the economy. The solutions are many, and some have not yet been fully tried.

ALTERNATIVES

Two suggestions to remedy the above situation and to provide new directions to fiscal policy are, broadly (1) the approaches of a school of thought that have come to be known as the supply side of economics, and (2) the approaches of pragmatic policymakers. The supply-side school of economics has many interpretations and its limits are still being defined. However, two distinctive schools of thought can be discerned within supply-side economics. Members of the first school have a fundamental philosophy of the state, while those in the second school concentrate their efforts on methods of eliminating the bottlenecks in the economy and of promoting industrial activity. The concern of both schools, however, is that budgetary instability should be avoided and that budgets should be balanced. Balancing of the budget can be done in several ways at many levels. Both contend that, as taxation levels have reached the point of becoming counterproductive, reliefs should be provided, tax levels reduced, and expenditures contained at the reduced level of taxes.

The first school of thought in supply-side economics emphasizes that people must be left free to choose and that the role of government, which has grown to be a giant providing all kinds of services, should be drastically reduced. Provision of educational, health, and community services, or of assistance to the unemployed or backward, are better undertaken through the private sector. The basic assumption in this approach is that government has neither the wisdom nor the competence to provide such services and that the community itself can
take care of its own interests and requirements. The debate concerning
the exact role of the public sector has been at the center of political and
economic controversies for quite some time. As a budgetary philo­sophy, it found acceptance in the early 1950s in the United States, by
which time the implications of the actual implementation of Keynes­ian economics began to emerge.\(^\text{16}\) The practical implementation of
this approach is sought through two measures—privatization and
constitutional limits on government spending. Privatization, like
supply-side economics, has varying connotations in different countries.
In essence, however, it implies a once-for-all transfer of some functions
from government to the private sector and a heavy reliance on
contractual arrangements for providing services. In terms of this
approach, the overall governmental responsibility for providing
services is accepted, but the medium for providing these services is
sought to be changed because the protagonists of this view see the
problem primarily as the unwieldy growth of the public sector, which,
instead of leading to cost savings through economies of scale, has led to
increased unit costs and expenditures. This approach is also based on
the belief that any prescription is better than the existing situation.\(^\text{17}\)
It is therefore proposed, with a view to protecting the consumer, that
some services may be handed over with government financing to
private management, which may perform these services better because
its motivation is likely to be different. Moreover, in view of the known
costs of contracts and the fact that costs in the private sector tend to be
lower because of lighter overhead costs, the rate of growth in public
expenditure will effectively be curtailed. An extreme version of this
approach, which better reflects a fundamental faith in the market
mechanism, is that the interests of the consumer, both in terms of
quantity and quality of services, are best served when the government
divests itself of its responsibilities and allows the private sector to
function in its place. The assumption of the first approach—that no

\(^\text{16}\) President Eisenhower stated as his budget objective in 1954 the following: “By
using necessity—rather than mere desirability—as the test of our expenditure we will
reduce the share of the national income which is spent by the government. . . .
government must play a vital role in maintaining economic growth and stability. But
I believe that our development since the early days of the republic has been based on
the fact that we left a great share of our national income to be used by a provident
people with a will to venture,” Budget Message to the Congress.

further efficiency is possible in government—may be considered as total lack of faith in administration and as a manifestation of defeatism. Its faith in the private sector's capability for providing the services may be considered naive. However, if this approach is accepted, privatization would impose new responsibilities on public agencies to ensure the quality of services, adding public costs to those already incurred on contracts. As illustrated in Chapter 5, private contractual services have a tendency to escalate in cost and, in some cases, may be more expensive than those of the government. Few services can be so privatized. This approach should perhaps not be seen in terms of rigid alternatives of either the public or private sector substituting for the other but in terms of improving the motivational and management systems in both government and private sectors and in facilitating a review of expenditure priorities. The extreme version, however, is more complex and controversial. Behind its touching faith in the market mechanism is the feeling that the operations of government, beyond the traditional ones of maintaining law and order and particularly in the economic sphere, are all encroachments on individual freedom and conflict with liberty. These philosophical premises can be argued at length but to no conclusion. The final choice is not merely a reflection of an individual predicament but also one's faith or lack of it in the progress made during the last few centuries. In the more technical context of fiscal policy, such divestiture of functions may imply that employment, economic stability, and amelioration of poverty would be left to the market mechanism. This may lead, as John Kenneth Galbraith has demonstrated, to public squalor and to private affluence and to a pattern of a state that is an antithesis to the conventional image of a state. 18

The suggestion relating to constitutional limits on spending implies an unusual degree of desperation and lack of faith in the governmental machinery of budgeting and expenditure controls. The main argument in support of such limits is that public pressures are exercised relentlessly by all interest groups and that the only way they can be checked is through constitutional limit that specifies public expenditures as a percentage of GDP, or insists on a balanced budget. It may be argued that constitutional limits are not immutable; the lawmakers

18 Social Democrats who forged the expansion of the state believe that reliance on market mechanism provides no acceptable social or political theory.
that set the limits can also change them. A more significant aspect, however, is that budgets cease to be flexible and may be ineffective in creating economic stability. Control of expenditures would shift from within government to external agencies and, if experience is any indication, such a shift would encourage escape mechanisms that would effectively nullify the purpose of the limits. The specification of legally enforceable spending limits is difficult, as the relevant elements are highly variable. Finally, limits are not by any means new, for governments already follow self-imposed limits on the level of the budget deficit or the share of the budget deficit to be financed by borrowing from the public or the banking system; under the proposal, the limits would become legal. It is doubtful whether such legality itself will work any miracles.

Those in the second school of supply-side economics emphasize that, as the major problem (in their view) is not lack of purchasing power but one of constraints caused by the high levels of taxation and regulation, these constraints should be reduced to redress the balance between saving and investment. Tax reduction, it is suggested, would stimulate production and permit more intensive employment of existing capital. It is recognized that tax reduction might not be possible in an inflationary environment, but it is certain that tax reduction will stimulate output so that revenues will indeed rise following a tax cut. Behind this “is a vision of the economy as a coiled spring held down by the weight of government. Remove the weight and the spring will reveal its inherent force.” In short, tax reduction is expected to release a miracle of productivity. The relevance of this is dependent on the tax structure and on the assessment of whether indeed it has been counterproductive. It is, however, doubtful whether tax incentives alone have these magical powers and whether equal, if not more, attention is needed on the structural factors, such as the level of technology and changing modes of demand. In its faith, this approach resembles the earlier confidence of the Keynesians in deficit financing as a means of bringing a rapid expansion in output. The reduction in regulation is to be considered in terms of the beneficial

19 Those who argue for constitutioal limits on spending believe that “fiscal policy is simply not a tool for creating economic stability.” This denial of the role of fiscal policy is not, however, warranted by the analysis of this approach. See Wagner and Tollison (1980), p. 17.
impact that it has on the industries and in terms of the relative welfare losses of the community. Regulation presupposes recognition of the harmful effects of conglomerates and other major organizations. Reduction in regulation has the potential effect of making them more powerful, and the very market mechanism that is the cornerstone of supply-side economics may no longer reflect the freedom that is sought.

Supply-side economics has a place in fiscal policy, but it is not the sole answer to current problems. It cannot function alone; it needs to be used in conjunction with demand management approaches. It also takes a long time to be effective because tax reduction does not bring about an instantaneous growth in output, nor does privatization reduce costs. The positive features of supply-side economics consist in a plea for a more detailed and systematic look at the current levels of taxation and expenditures and their composition. The relevance of supply-side economics should preferably be at a disaggregated level in terms of each tax and category of expenditure. If it is so viewed, it may not reach any different conclusions than those reached through the Keynesian framework. The current debate, however, is carried out at a general level, with each school believing in an apocalyptic vision of the future—one foreseeing endless inflation and total loss of freedom, and the other envisaging the disappearance of the state and with this the neglect of the poor. The more mundane problems of fiscal policy need to be seen in terms of the allocative efficiency of resources.

The problems of expenditure growth, however, are real and need to be addressed if fiscal policy is to have relevance in the management of the economy. It is here that the approaches of the pragmatic school of thought offer some positive directions for the conduct of fiscal policy. These approaches recognize that public expenditures rise because of political pressures and the absence of market discipline and competition. They believe in a community that seeks to fulfill its requirements through government. The important objective is not to perform the fiscal functions differently, but rather to perform them better or more efficiently. It is also recognized that the community has an increasing demand for public services while at the same time it resists increases in taxation and other changes. This approach, therefore, seeks to foster a link between services and payments, on the one hand, and a better use of the fiscal instruments, on the other. There are, as noted earlier, no immutable levels of public expenditure that offer stability or inflation
Fiscal Policy Parameters for Budgeting

growth. Each country has to find its own level by experience. In terms of these pragmatic approaches, governments should aim at achieving a spending level that does not put undue constraint on the conduct of monetary policy nor limit work or investment incentives in the private sector. In achieving this level, fiscal policy should not merely be determined but is also viewed by the public as decisive in reducing the inflationary pressures in the economy. Since major problems of the past have largely arisen from frequent shifts in policy, changes should be minimized in order to provide a degree of stability to fiscal policy in the medium term. Toward this end, the overall levels of taxation and expenditure should be reconsidered, and priorities should be reorganized in the light of the changed economic situation. Tax incentives might be restructured, and in order to facilitate the link with payments, user charges might be introduced in selected areas. Within expenditures, the structure of subsidies might be revised and made more specific. More significantly, in view of the continuing need for commitment of growth, resources might be selectively redeployed and greater emphasis placed on investment expenditures and their efficiency.

The pragmatic approaches aim at a constructive role for fiscal policy that is generally applicable to both industrial and developing countries. Conversion of generalities into practicalities is, however, the task of fiscal machinery, which is the subject of the following chapters.
CHAPTER TWO

Purposes of Budget and Determinants of Public Expenditures

Of course the first thing to do was to make a grand survey of the country she was going to travel through.
LEWIS CARROLL, Through the Looking Glass

During the last five decades, budgeting has developed naturally and spontaneously rather than in a planned manner and, to a certain extent, empirically rather than theoretically. It has been heavily influenced by political systems, economic theories, management approaches, accounting principles, and the conduct of public administration. While the specific influences of each discipline may not lend themselves to precise identification, Table 4 indicates the significant aspects of budgeting, the influences from different social sciences, and the areas covered.

Budgeting is an intricate and complex process, containing many pieces if viewed as a puzzle. The pieces cannot always be arranged sequentially because several of them interact simultaneously. Although a beginning of the budget activity is indicated for purposes of administration, it is actually a continuous process and therefore does not necessarily follow a sequence in which it should be examined. What is important is that these pieces should be brought together to reveal their interconnections. This chapter combines the general and preliminary elements of the budgetary process and is self-contained, while also serving as a prelude to a more detailed discussion of specific aspects in the following chapters.
### Table 4. Approaches to the Study of Budgeting

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### BUDGETING: EVOLUTION AND PRESENT PURPOSES

Budgeting in the early stages of its evolution was concerned with serving the purposes of legislative accountability. The long struggle with the monarchs culminated in control of taxation by the legislatures. Having won some right to impose, amend, or approve the tax proposals, legislatures turned their attention to control spending. As a
result, legislatures required the annual submission of budgets containing the statement of expenditures and a statement of the revenues needed for the purpose. To supplement these functions, appropriate institutional machinery was evolved for raising monies and for ensuring that they were spent with due observance of regularity and economy. In due course, central agencies were set up within the government to oversee the financial management of government. As governments became larger, the spending agencies were entrusted with more responsibilities. Within this broad framework of the division of responsibilities between central and spending agencies, gradual developments took place in the nature and approaches of budgeting to reflect the changing undercurrents in the economy.

World Wars I and II and consequent increases in expenditure, the Depression and the associated changes in the approaches of state and fiscal policy, the inexorable growth in government expenditure after World War II, and the need for economic stabilization and achievement of full employment have, as noted earlier, influenced the budget objectives. The features associated with the classical or early budget systems were their unity, comprehending all the transactions of government; regularity—requiring the annual submission of budgets; accuracy—mandating that revenue and expenditure estimates imply a bond with the legislature and a basis for their approval; clarity, so that the community and its representatives could understand and deliberate on its contents; publicity—requiring that it be a public document and that its contents be known to the community; and, finally, operational adequacy as a tool of administration within government. The legislative accountability inherent in these principles continues to govern the budget today. In addition, the budget has acquired dimensions of planning and management and has become a key instrument of national policymaking.

Broadly, the purposes and associated features of the budget may be considered in terms of three aspects—as a tool of accountability, as a tool of management, and as an instrument of economic policy. Budgeting in the final analysis, regardless of the type of legislature, is a political exercise. From this point of view, a budget is expected to state clearly the purposes of expenditures and provide them in a form that will be useful for legislative action. In addition, the budget is the

1 For a discussion of these principles, see J. W. Sundelson (1938).
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instrument for accountability, in that the government agencies are responsible for the proper management of funds and programs for which funds are appropriated. It is also a tool for management, because a budget, as an operational document, specifies either directly or implicitly the cost, time, and nature of the expected results.

Budgeting as an instrument of economic policy has more varied functions. First, in policy terms, it indicates the direction of the economy and expresses intentions regarding the utilization of the community's resources. In operational terms, it leads to the determination of the national growth and investment goals and, in more detail, with the allocation of resources among consumption, transfer, and investment outlays and among sectors. Second, a major function of the budget is to promote macroeconomic balance in the economy. The policy choices in this regard include specification of the amount of growth that is compatible with employment, price stability, and balance in the external sector. The economics of budgeting require that due regard be paid to revenue, expenditure, and monetary policies. Available revenues must be allocated among various uses so as to maximize the benefits received. The total revenues required for the purpose are to be managed so as to ensure an equitable distribution of the tax burden and have minimal detrimental effects on the economy. The budget will have to strive toward equating the social benefits of expenditure and the social cost of withdrawal of resources from the private sector. The financing of the budget deficit should be in conformity with the goals of growth and price stability and should be coordinated with monetary policy. In developing countries, this would also involve a careful assessment of foreign aid and external borrowing. Third, with the recent emphasis on distribution of resources in an egalitarian fashion, the budget has become a vehicle for reducing inequalities. The roles of taxation and expenditure programs, as well as the pattern of their distributional effects, must be continuously mapped by the budget. Certainly, distributional goals are sought to be achieved through a variety of instruments, and the budget is an important one. Fourth, the budget should be so organized as to permit a quick and meaningful measurement of its impact on the national economy as a whole. It should permit a determination of the government's share in national income and the extent to which growth and associated objectives of government are fulfilled by the budget. During recent years, there have been significant advances in the
general understanding of the relationship between the budget and the economy and of their reciprocal impact. Associated with these is the recognition that economic policy changes take time to become effective. In turn, the budget is perceived not merely in terms of one year (although for legal purposes, this continues to be the case) but in terms of a period of years. The budget is increasingly visualized as an annual part of a medium-term plan. The structuring of the budget is also expected to fulfill a number of institutional requirements that in turn reflect, although not comprehensively, the complexity of the tasks of economic management. The budget must have a meaningful correlation with the development plan, assist the central bank in assessing the impact on credit and financial institutions, and, in a narrower way, facilitate government management of cash balances and debt.

The above functions are converted into more tangible policies in the budgetary process. The incomes and expenditures of government are decided upon, approved, and realized while a number of other decisions are being taken. The process involves the generation, transmission, and utilization of large amounts of information of an immense variety. The budgetary process has also developed, over the years, to reflect these tasks. Thus, in describing the budget process, caution is needed in ascribing it to a stage of budget development. In an ideal sense, reflecting the cumulative experience of the years, the budgetary process can be described as one where there is first an establishment of goals in the light of available data and recognition of economic, political, and administrative constraints (Chart 1). The next stage consists of the development of plans and programs for short, medium, and long terms. This stage involves looking ahead at issues and alternatives. More specifically, it involves the preparation of projects with sizable outlays. Experience indicates that, on average, the identification, preparation, and selection of projects, as well as determination of their financing, take up to a decade. This consideration alone requires organized forecasting. The formulation of a development plan is followed by the annual budgeting or the allocation of resources. The implementation of the budget involves the ongoing recognition of new issues and reallocation of resources. The final stage is the appraisal and evaluation of the implemented budget for accountability and, more significantly, as feedback for the formulation of new goals. Each stage leads to the next, facilitating
Chart 1. Budgetary Process

1. Establishment of goals, objectives, and policies
2. Reporting and monitoring of programs; adjustments and evaluation
3. Appraisal and evaluation
4. Development of programs for short, medium, and long terms
5. Allocation of resources
6. Execution of the budget
7. Short-term changes in the budget, and reallocation of resources
8. Data collection; review of data; recognition of economic and other constraints, assumptions, and other inputs
9. Projections and forecasts; formulation of criteria for selection of programs; recognition of supporting programs
10. Short-term, medium-term, and long-term financial plans; alternative fiscal policies; priorities
11. Economic, financial, and program analyses; annual allocations; rapport between financial and physical aspects; formation of operational targets
12. For major projects, identification, preparation, and appraisal of projects

Assignment of specific responsibilities; achievement of targets within time/cost requirements
decision making on the policy, accountability, and management aspects of the budget. At each stage, there are a number of issues. But before considering the specific operational issues, it is appropriate to raise the question of how public expenditures are determined and to review the body of theoretical literature available. Readers who have greater interest in the operational aspects of budgeting may move on to the following chapters.

DETERMINANTS OF PUBLIC EXPENDITURES: THEORETICAL APPROACHES

The analysis of public expenditures and their determinants is a complex task that has been exacerbated somewhat during recent years by attempts at quantification and formulation of views on their patterns of regularity. Various theories have been proposed during the last three decades to offer explanations of different aspects of public expenditures. Several of them are normative and do not seek to offer an empirical or operational theory of budgeting. Some of them are models, which, depending on the choice of the researcher, are based on assumptions and seek to analyze the effects of prices, income, income distribution on the pattern of public expenditure. Each one offers, it seems, an incomplete explanation of a complex phenomenon. Consequently, notwithstanding the numerous efforts, no comprehensive theory of public expenditure has yet been developed. The literature is, however, prolific and varied. Although it is quite unlikely that reference to academic theories and writings will be made in the day-to-day administration of budgeting, it is helpful to have an understanding of their basic content to gain a better appreciation of the whole art of budgeting. The following discussion does not attempt a detailed survey of the literature but is primarily concerned with the dominant trends relevant to budgeting.² The theories contain several elements but only those strands of thought that have a direct impact on budgeting, as distinct from the wider philosophical issues relating to social choice, are considered here. A detailed survey is obviously

²For detailed surveys of economic literature, of which there are many (and still more on the way), see Jesse Burkhead and Jerry Miner (1971); Peter O. Steiner (1974), pp. 241–357; Dennis C. Mueller (1976), pp. 395–424, and (1979).
inappropriate, for it would divert attention from budgeting to the broader issues of public finance. In considering these theories, three major qualifications need to be kept in mind: (1) they have no settled body of knowledge, (2) they deal with societies that are essentially democratic, and (3) to a large extent, they were developed in the western democracies.

In the early period of its development, budgeting was essentially considered to be an administrative process and no specific attention was paid to expenditures. The Cameralist writers of Germany, who dominated thinking in this regard from the middle of the sixteenth to the end of the eighteenth centuries, viewed civic problems from a common point of view and attempted to systematize the administrative routine of fiscal departments. This tradition had a heavy influence on the approaches of British writers during the nineteenth century, when James Mill and John Stuart Mill considered financial matters to be a chore of administrative and political forces. In the same period, continental writers, particularly those from Italy, believed that public expenditure was to be considered as an integral part of fiscal analysis. To the Italian writers there were three types of states—the monopolistic state, in which a ruling clan or group comes to power and uses governmental machinery to further the welfare of its members; the individualistic state, in which the primary concern of the state is to provide welfare, which is viewed as the sum total of the individuals' requirements; and the paternalistic state, that usually transcends the sum total of society's requirements and may provide services that are different from individual wants. Writers like De Viti de Marco, who embraced the individualistic state, believed that consumer sovereignty or individual preferences should be the basis of society and that social choice should reflect the individual choice. Other Italian writers, like Mazzola tended to take the paternalistic state approach and underscored the need for the political authority to impose a policy of general welfare. These two trends—individual preferences for state services and their aggregation, on the one hand, and the general welfare concerns, on the other—were the foundation of all the subsequent theories of expenditure in their normative, positive, economic, political, and sociological settings. It will be evident from the

following discussion that current academic discussions basically revolve around these two themes in various forms.

The theories that shed light on the determination of public expenditure—on its total magnitude and composition—may be divided into economic, organizational, and empirical schools. Chart 2 shows the theories that form part of these schools. The theories considered here have several components, some of which may be viewed as political or economic. A criterion for distinguishing them on either basis is somewhat difficult to choose in a practical subject such as budgeting. Public finance itself is, as Dalton remarked, a borderline subject between economics and political science.4 Budgeting, as an extension thereof, is at the crossroads of economics, political science, public administration, and a host of other social disciplines. It is primarily viewed here as an exercise in applied economics—an exercise that can and does take place in a regular political framework. To an extent, therefore, the classification in Chart 2 may be considered arbitrary. Basically, however, three concepts of budgeting are evident in the economic and organizational approaches:5 (1) budgeting as an optimizing process that deals essentially with normative theories of resource allocation, which in turn deal with the maximization of individual and social welfare; (2) budgeting viewed as an internal bureaucratic process and comprising theories that compare the approaches of governments toward resource allocation to the firms in the commercial world; and (3) empirical or descriptive approaches that link budget determination to the demand for services and which view the budget as being finally decided in a bureaucratic process with reference to endogenous variables (cost of services) and exogenous factors (availability of revenue). The theories advanced as a part of the optimizing school are considered below. The comparison with commercial firms, which primarily relates to decision making, is considered in Chapter 4 while the descriptive approaches to budgeting are considered in Chapter 3.

MARGINAL UTILITY

An important school of thought in the economic approach to the determination of the composition of expenditure, and thus of

Chart 2. Approaches to Expenditure Analysis and Budgeting

Economic approaches

Normative or neoclassical approaches

- Marginal utility approach
- Social choice
- Market failure and public goods
- Choice in a democracy
- Voter behavior
- Positive approaches
- Neo-Marxist approaches
- Applied approaches

- Pure theory of expenditures: allocation and distribution of resources: general and partial equilibrium treatment
- Unanimity rule, optimal majority, vote trading
- Self-interest theories
- Behavioral and empirical studies
- Public and private sector relationships: conflicts
- Incidence and impact studies, Cost Benefit Analysis, etc.

Organization and process-oriented approaches

- Bureaucratic process
- Optimizing or decision-making process
- Budget as an externally determined event
- Optimal control

- Conflict resolution: organizational learning, maximizing behavior of bureaus
- (a) Rational or normative decision-making approaches to allocation of resources
- (b) Satisficing and incremental approaches
- (a) External variables such as population, level of resources, etc.
- (b) Cost of services—performance approach
- (c) Result of interaction among different groups
- Self-regulating control mechanisms that adjust to changed circumstances

Indicates influences among major groups
budgeting, is the one relating to marginal utility, which was developed in the early 1920s. The theory held that an individual will spend to satisfy his wants in a manner that will achieve a certain balance among different types of expenditure and ensure that the marginal return of satisfaction is the same for all of them. This theory was first adapted to fiscal control by Hawtrey, who observed that "the purpose of the system of treasury control is to secure a uniform standard of the financial sacrifice involved in all the activities of all departments of government."6 Hawtrey did not, however, use the term marginal utility, although he implied it to be the basic rule. Developing this theme more explicitly, Pigou wrote "just as an individual will get more satisfaction out of his income by maintaining a certain balance between different sorts of expenditure, so also will a community through its government. The principle of balance in both cases is provided by the postulate that resources should be so distributed among different uses that the marginal rates of satisfaction is the same for all of them. . . . Expenditure should be distributed between battleships and poor relief in such wise that the last shilling devoted to each of them yields the same real return."7

The principles of marginalism have been debated extensively in the literature for more than six decades. The concept is normative and is a logical construct, and its transition to empirical and practical levels is a difficult problem that has not yet been solved. The first problem concerns the measurement of utility. While an individual is in a better position to ensure that a unit spent brings him, at the margin, the same utility, the application to government finance is rendered doubtful because government consists of a huge machinery involving several heterogeneous groups of interests and of people that make it impossible to compare utilities. Pigou himself recognized this and cautioned that a complete balance of equimarginal satisfaction may be possible only when a community is literally a unitary being, with the government as its brain. The concept lacks an empirical base, in that it cannot be subjected to a test. Marginalism is possible, even in theory

only when there is an objective function in terms of which utility can be evaluated. This is rendered difficult because of the vast array of services and goals of government and the absence of an acceptable measure. Even if the concept is applicable in a framework based on assumptions, it can at best offer a guide—as a sort of general principle for the use or distribution of a fixed sum rather than as a standard for determining the total. In public finance, there is an iterative relationship between total expenditure and its components. To the extent that the principle itself does not deal with total expenditure, it offers only partial guidance.

The absence of an economic theory to rear budgeting as a part of applied economics prompted several writers to examine the matter. Lewis offered a model in 1952, in which an attempt was made to render operational the marginal utility principles. His model comprises three basic approaches—marginal utility or relative value, incremental analysis, and relative effectiveness. The principle of marginal utility implied (1) measurement of relative values and (2) assessment of the alternative uses of financial resources. In practical terms, this approach would involve the computation of costs of various activities and the comparison of the relative values of results obtained from alternative uses of funds. The incremental analysis approach suggested that the analysis should be applied to the increments of resources rather than to the sum total of resources. If applied to the total, i.e., increments and previous resources, the law of diminishing utility would apply and additional units would yield less value. Comparison is therefore to be made at the margins. The relative effectiveness approach suggested that the relative values cannot be compared unless there is a common denominator or a common objective. Lewis contended that such a denominator was available through the political framework that specified common ends. Lewis was aware that the implementation of his framework was difficult, but he thought that it offered a useful direction. Supplementing this three-pronged approach, Lewis formulated an alternative budget plan, under which each official concerned with spending would formulate alternative skeleton plans for utilization of resources, and he suggested that these alternative budgets would offer better proxies for relative

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8See, for example, V. O. Key, Jr. (1940), pp. 1137–44.
Lewis's attempt, although not so stated in his contribution, essentially consisted of giving a budgetary and operational framework to cost-benefit analysis, which was then prevalent in some agencies of the U.S. Government. Relative value was nothing more than a comparison of the interproject benefits, and incremental analysis was a basic ingredient of cost-benefit analysis, in that it was concerned with increments and not with sunk costs. Relative effectiveness, in his analysis, was equivalent to the specification of objectives of projects. In short, it was an effort to incorporate the rationality approach in that a project was to be undertaken only when benefits exceeded costs.

In analyzing the problem, however, Lewis did not tackle the many operational problems in the measurement of all costs and all benefits, nor did he deal with the issues in the specification of objectives, which will be evident from the application of Lewis's model to the fourfold classification of expenditures proposed in Chapter 1. His model implies that, in regard to the first category of expenditures (on defense and other social services), analysis of benefits and costs can be made if the budget categories are comparable. In regard to the second category (goods and services produced by the state to be sold in the market), prices should be fixed with reference to marginal costs but this raises difficult problems of measurement in view of the joint nature of the products. As to the third category (transfers to productive sectors and transfers to households), enumeration of costs and benefits of government intervention differs according to type and much is dependent on the incidence of subsidies. These examples illustrate that the economics of public expenditure are wider than the application of marginal principles. Further, Lewis's model does not suggest how to determine total expenditure. This shortcoming is partly compensated for later by the opportunity-cost principle, which implies that the measure of relative value should be applied not only to the public dollar but also to the private dollar. Use of a resource by government implies that its alternative private uses have been forgone. In order to be allocatively efficient, resources can be used by government only when greater output cannot be obtained for the same resources in the private

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10 This feature came to be operational later as a part of Canadian A, B, and X budget systems and as a part of zero-base budgeting in the United States during 1976-80. This aspect is considered in Chapter 11.
sector. But the selection of a rate that would reflect the opportunity cost and the measurement of costs and benefits continues to be a major problem. Indeed, it appears that budget preparation would be easier and could even be automated if only expenditures could be tested against some unique formula of alchemy.

**PUBLIC GOODS APPROACHES**

Developments in neoclassical fiscal theory during the 1950s primarily consisted of theories of public goods and the process of their selection for budgetary purposes. Samuelson in his paper, "The Pure Theory of Public Expenditure," referred to a system that included private consumption goods and collective consumption goods (those that all enjoy) and assumed that each individual has a consistent set of preferences for both private and collective goods. With the help of equations and diagrams, Samuelson showed how the planner would derive for each individual his demand function and the collective consumption goods that would contribute to his utility maximization. In this system, the planner is expected to have an omniscient presence and be able to ascertain individual preferences even when they are not voluntarily revealed. Samuelson attempted to show the combination of public and private goods and their distribution that would maximize social welfare. His concern was with the total community's welfare and with all the goods; it did not have much to do with the central reality of the budget in the ordinary world.

The major contributions of the neoclassical theories of expenditure determination revolve around public goods and the implementation of the objectives of budget policy. Public goods, although variously defined, are those for which no private mechanism exists to provide them and which are consumed in equal amounts by all; people who

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11 In the early 1950s, the growth of government and its expenditures brought repeated pleas for the introduction of market-oriented pricing mechanisms and use of opportunity-cost principles for government allocation of resources.

12 Bernard Shaw's remark in *Man and Superman* that "government presents only one problem: the discovery of a trustworthy anthropometric method" is relevant in this context.

have not paid for them cannot be excluded from their enjoyment.\textsuperscript{14} Public goods are also likely to be qualitatively different from those provided by the private sector (in regard to merit wants) and may have a distribution impact different from privately provided goods and services. Public goods, used broadly to correspond with all goods and services provided by government, include a wide variety of goods and the demand for them becomes an important element in the determination of public expenditures. In this context, Musgrave's concept of the three branches of the public household becomes relevant.\textsuperscript{15} Musgrave is doubtful about the planner in whom Samuelson has so much confidence, and he contends that governmental functions are performed through three branches of decision making—allocation, distribution, and stabilization. The function of allocation is to provide goods and services toward satisfaction of wants. However, as there is no market to reveal the preferences of the community, a political process that acts as a substitute for a market mechanism is assumed. In this case, there should be a voting process that would reveal the community's preferences. For purposes of formulating the budget, it is assumed that the proper state or desired state of income distribution is exogenously determined as is the stabilization function. Once those goals are given, the manager in charge of allocation has to analyze the preferences for public versus private goods. Taxes to finance the allocations are determined on a benefit basis, following Wicksell's principles. For the determination of the distributional adjustments, it is assumed that the political process would have specified proper weights for distribution. The interdependence between distribution and allocation is recognized, and it is expected that, in attaching weights for distribution, the impact of allocation on factor incomes is fully taken into account. The function of stabilization is to ensure full utilization of resources while maintaining the value of the money. Here again, it is assumed that some form of consensus is achieved on

\textsuperscript{14}It is contended that in the modern age exclusion of certain groups of people from enjoying the benefits is technologically feasible, but the cost of such prohibition is likely to be considerable and the state may prefer general enjoyment as a less expensive alternative. Given this nonexclusion and the free-rider problem, preference revelation in the public sector appears impossible. This also poses a problem for the measurement of public output. The market failure to provide information on citizen preference is sought to be compensated for through the political process.

\textsuperscript{15}See R. A. Musgrave (1959), pp. 3–27.
the level of unemployment and price stability or inflation. Within this framework, the managers of the three branches are expected to consolidate their separate budgets.

In Musgrave's framework, the decision maker's role is almost mechanical and his responsibility consists of conforming to the revealed preferences to obtain optimality in resource allocation. The difficulties primarily relate to the mechanism for revelation of preferences. Musgrave's distribution function is concerned more with the aggregate distribution between public and private households than with distribution among groups. In operational terms, his framework implies that if the budgeteer can conduct an opinion poll or organize mechanisms to ascertain the community's views on public goods, the pattern of distribution, and the goals of stabilization, the act of budgeting becomes a mere arithmetical exercise. It also implies, in operational terms, that a budgeteer works in a political sphere. So stated, this might appear a commonplace and obvious conclusion. The major merit of Musgrave's contribution lies in shifting attention to the political processes and to the interaction between the community and the state. Admittedly, while Musgrave's theory sheds more light than Samuelson's analysis, in terms of offering an operational framework, both theories are incomplete and are distinguished by degrees of difference in the formulation of paradigms.

**Public Choice**

The recognition of the importance of the political processes for revealing public preferences has in due course contributed to the growth of "public choice" theories, which cover a wide range from voting solutions and conflict resolutions to property rights. Collectively, they can be described as the analysis of nonmarket decision making or the application of economics to political science. In considering these theories, it is appropriate to consider also the political premises, albeit briefly.

Allocation of funds in the final analysis, it is recognized, is a political process. What then is the theory of budgeting in a democracy? What are the approaches of the community to the budget? How useful and precise are they for revealing the determinants of public expenditures? A significant effort was made by Downs to offer
some useful analysis of these political processes.\textsuperscript{16} Downs's theory was primarily based on the U.S. system, although parts of it could be applied to less democratic societies as well. In his framework, governments set both revenues and expenditures to maximize their chances for winning the election,\textsuperscript{17} and the budget itself is arrived at, not with reference to overall spending and taxation but through a series of separate policy decisions based on gains and losses of votes.\textsuperscript{18} However, as some budget proposals may not be adaptable to a gain/loss calculation, they may be grouped into convenient blocs, such as defense and nondefense. The government will provide what voters want (reminiscent of the consumer sovereignty school of public finance) but not necessarily what is beneficial. Downs, however, branches off from the benefit theory of allocation of resources, and he suggests that budgets tend to be smaller in a democracy because each benefit entails some cost to the taxpayer and costs are likely to outweigh the benefits. Even if there is full information and identification of benefits, a taxpayer may desire a smaller budget and ask for the elimination of projects that he does not benefit from. To Downs, the central reality for government is the citizen's vote, not his welfare.

Downs's theory has been subjected to serious review by political scientists and economists. The former group considered it to be too simplistic and unrealistic. Economists, while questioning parts of it, have made further modifications that later emerged as the public interest or public choice schools. From the technical viewpoint of budgeting, Downs's theory suffers from many limitations. It ignores the role of the state and views the budget as a mechanical and predictable exercise. The voter's reaction on costs is contingent on the tax burden and its distribution. The voter is also a game player; his concern is not only with direct benefits but also with externalities. In Downs's calculation, each decision is viewed as an independent package, without any inherent interdependence. The budget is viewed in a vacuum, devoid of its economic function. If Downs's theory were


\textsuperscript{17}It could be argued that totalitarian regimes follow similar policies for perpetuation in power.

\textsuperscript{18}See also, Anthony Downs (1957). Downs's main argument in his book is that political rationality is different from economic rationality and that the former introduces distortions in resource allocations.
correct, it could be argued that expenditures and taxes should have been going down rather than up.\textsuperscript{19}

The public choice theory extends Wicksell's view on government as a quid pro quo exchange of services for payments. The principal issue to be determined is the applicability of a mechanism as the nearest equivalent or proxy for market behavior. The basic assumption of public choice theory is that governments are collectivities of utility maximizers—officials in government, elected representatives, government agencies, and interest groups. Their concern is with the institutional framework within which budgets are chosen rather than with the articulation of criteria for budget efficiency. These concerns have been reflected in various theories that are now integral elements of the public choice school. Principally, they relate to voting rules and voter behavior. Within the voting rules, an aspect that does not need any elaboration here, is the relationship between the individual and the democratic machinery. Implications of the unanimity rule, reflecting a unanimous consent for public goods, as well as optimal majorities and their relevance for permitting an efficient allocation of resources, are considered to be integral parts of these theories.

Following Downs's approach, studies were also made on the self-interest of the voter and how he would maximize his own welfare. The impact of these studies on budgeting relates to (a) the viability of the political process as a proxy for the market forces and (b) the implications of utility maximization by government agencies. Notwithstanding the considerable amount of literature, it appears that the revelation of collective preferences through the democratic process does not offer a foolproof mechanism. Transitivity in individuals may not translate itself into collective preferences. Market forces are different from voting considerations. In the market the quid pro quo is direct; in the voting booth it is indirect and remote. This difference alone may generate a different responsiveness in the voter. Bargaining among individuals and groups, which is an ingredient of voting power, does not permit optimal allocation of resources. Also, there is the fundamental issue whether the services produced by government are in any way connected with the prices citizens are willing to pay for them.

\textsuperscript{19}In a dynamic setting, while actual taxes and expenditures may move upward, they may be less than what they would be otherwise. Downs does not offer an evaluation of how the levels of "what would be" are ascertained.
Clearly, if weight is given to the role of the paternalistic state or to leadership, the pattern of collective wants may not be a spontaneous one but may be created. On a more fundamental level, critics of the utility maximization approach contend that voters lack the information to maximize their net personal benefit and do not perform the calculations to identify the optimum benefit. Self-interest itself has been subjected to both a narrower and a broader version, and in the latter it has been stretched to cover paradoxically a selfish concern for the welfare of others. The demand for goods is influenced both by utility and the willingness to pay and these two may not be equal in magnitude. These theories, however, consider collective preferences at an aggregate level and have shown no great concern for who pays for what. While preferences do indicate the broad directions of the voters’ needs, the theories are not very helpful in providing an operational process in which the magnitudes of outlays and the time frame for rendering those services are to be determined.

The proponents of the utility maximization school suggest that the adoption of the maximizing approach by government agencies would invariably lead to larger budgets, bigger bureaucracies, greater governments, and more problems stemming from the financing of the budgets. Proceeding on this basis, and somewhat paradoxically to the utility maximization paradigm, many public choice theorists argue for a reduction in the size of the government and for decentralization of authority. The policy implications of this approach have been considered in Chapter 1, but what it means for the bureaucracy may be noted. Bureaucracy, if the pejorative connotation is ignored, is the structure of the government that exists to solve tangible problems and is one that is expected to have an ongoing direct contact with the people. Properly organized and well motivated, bureaucrats may resolve rather than exacerbate the moral dilemmas of democracy, and it is believed that they serve collective and not personal interests.

In all this, the role of fiscal illusion cannot be ignored. The public choice theory contends that the institutional manner in which citizens are required to pay for government can affect taxpayer perceptions of the price of government and hence the size of the government. For example, during periods of inflation, taxpayers may object less strenuously to increases in public expenditure.

For a discussion of this approach, see William A. Niskanen (1971).

The growth of the spoils system in preference to the merit system has frequently contributed to the feeling that bureaucracy at its worst is an extended form of patronage.
Bureaucracy operates the financial resources of the state, and the system provides ample checks and balances. The approach also neglects the heterogeneity of the bureaucracy. Indeed, in budgeting, the conflict is between those who have an obligation to provide services and those who have an obligation to the society in terms of contained financial burdens. The fiscal paradigms, therefore, remain conceptual and offer guidance that may seem obvious.

**POSITIVE APPROACHES**

The positive approaches, unlike pure theories, are more concerned with the empirical growth of public expenditures and deal with the formulation and verification of certain hypotheses. Literature on this, which reached a sizable magnitude during the 1960s, has shown signs of abatement and now seems to have received a setback. To some extent, the current state of apathy may be due partly to what appears to be wrong approaches in retrospect and partly to statistical difficulties inherent in the testing of public expenditure growth. Most of the work was guided by a search for empirical laws, or explanations and the difficulty of formulating laws in the social sciences has been a significant factor contributing to lack of progress in this area.

The earliest theory advanced is that of Adolph Wagner (1876) in what has come to be known as the law of increasing state activities, suggesting that the share of the public sector in the economy will rise as economic growth proceeds, owing to the intensification of existing activities and extension to new activities. There have been, however, variations of this law in that several researchers interpreted it in their own way and proceeded, in some cases, to test it empirically. Among these, four hypotheses for the empirical verification of Wagner's law may be noted: (a) government expenditure must increase at an even faster rate than output; (b) in growing economies the share of public consumption expenditures in the national income increases; (c) as a nation experiences economic growth, an increase must occur in the activities of the public sector and the ratio of increase, when converted into expenditure terms, would exceed the rate of increase in output per capita; and (d) there would be a rising share of the public sector or ratio of public expenditure to GNP in the context of the development of a country from low to high per capita income (i.e., the elasticity of public expenditure as a share of GNP per capita is greater than unity).
The results of these tests show, apart from differing interpretations, the lack of universality, and they show that the growth of expenditures is far more complex than is evident from the tests. Musgrave contends that instead of seeking an explanation for the total expenditure, it may be more appropriate to adopt a disaggregated approach through a study of expenditures of government on capital formation, consumption, and transfer payments.\(^\text{23}\) Analysis of these factors, however, reveals different propositions that are considered below.

During the 1950s and 1960s, attempts were made to provide greater empiricism and to make international comparisons in expenditure growth. These attempts fall into two categories: (a) those that emphasized the economic growth and modernization factors on the demand side,\(^\text{24}\) and (b) those that explained the supply side, treating changes in government expenditure as results of social disturbances or wars.\(^\text{25}\) The latter studies proposed that increases in public expenditure during wartime exceed the limitation on taxation, thereby permitting higher postwar civilian expenditures. This increase in expenditures would have a displacement effect, a concentration effect, and an inspection effect. The displacement effect primarily consisted of shifting public revenues and expenditures to new levels, where they would be accompanied by changes in the relative importance of central and local governments, with the former assuming new functions and taking over functions of the latter (concentration effect). Simultaneously, these shifts would force the attention of governments and people to problems of which they were formerly less conscious (inspection effect). This hypothesis generated numerous statistical studies to test its validity. The results of the tests show conflicting results, but it is evident that the displacement effect is one kind of explanation for certain situations.

Several studies have also been made on the behavior of the components of expenditures. Some of the hypotheses tested, from which there were varying results, are the following: (1) rich countries spend more on defense, social security, and food subsidies; (2) the

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\(^{24}\) See the pioneering study by S. Fabricant (1952). For an international comparison of revenues and expenditure, the first effort which started a trend was by Martin and Lewis (1956), pp. 203–44.

pattern of spending in export economies is different from others in that they tend to spend more on education and health; (3) the aggregate level of expenditures is related to the outlays on defense and economic services; (4) as GNP grows, the shares of civil consumption expenditures and general administration expenditures remain the same; (5) increased government revenues are often accompanied by corresponding, if not greater, increases in expenditures, with the possibility of a drop in public savings; (6) economic determinants do not fully explain nondefense spending; and (7) consideration must be given to social determinants.

Statistical approaches have their limitations and when applied to government expenditures have not made much headway in providing useful indications of expenditure determinants. Most international comparisons are based on cross-section analyses and appear to have ignored time as a variable. The studies did not offer a reliable guide for the analysis of expenditures or for decision making. Their main contribution may have been an unintended one, in that they provided a useful diversion from the normative approaches in offering selected explanations of expenditure growth.

Theories and studies proved to be interesting but the establishment of a law, or even the pursuit of a law, that would explain the determination of public expenditure appears to be futile. As Bird stated in a study of Canada's public expenditure a full understanding of government expenditures and their growth over a period of time requires a greater recognition of social and political factors.26 Offering a broad-based approach, he observed that five sets of factors—environmental, technological, economic, political, and administrative—influence the growth of expenditure.

Government finances, notwithstanding their importance, did not receive much attention in the hands of Marxian scholars. This gap has, however, been filled, albeit to a minor extent, by O'Connor,27 who offers an explanation for the fiscal crisis in the modern state. In his view, a fiscal crisis would emerge because of the tendency of expenditures to outstrip revenues. Expenditures perform two contradictory functions—accumulation in terms of provision of social overhead capital to support private capital formation, and the
legitimate function, comprising police, welfare, and related expenditures for the maintenance of law and order. The inherent conflict between these two functions, it is argued, will intensify and cause a fiscal crisis. This, however, is primarily a quasi-political interpretation of the fiscal approaches of the state and does not offer an explanation of the determinants of expenditure growth.

The applied approaches to government expenditures deal with their impact and are considered, respectively, in the sections below on incidence and economic analysis. Note should be made, however, of the optimal control approaches that have come to be advanced recently but have not yet become operational. The approaches of this school emphasize the utilization of econometric techniques for formulation of government macroeconomic policies, including budgetary ones, and suggest, based on the parallel of industrial operations, self-balancing mechanisms so that expenditures grow or are reduced automatically according to selected indicators. This approach is concerned more with changes in expenditures than with their determinants and it views budgeting as a mechanical exercise.

MARKET AND NONMARKET FAILURES

The economic literature, as noted above, is concerned with the provision of public goods. The need for public goods arises because of the nature of the public goods themselves and because of the imperfections of the market system. When economic activities create externalities—benefits or costs to others—these must be considered in production decisions and not doing so will imply a less efficient allocation of resources. There are, however, several externalities that do not enter into the private producers' calculation. The existence of such externalities and the need for correcting them offer a basis for government intervention and regulation. Similarly, in industries such as the traditional public utilities, original capital investments are heavy and are subject to declining marginal costs, which, in turn, reduce the prospect of competition. Thus, the government emerges as an investor. The concerns of the state also require that attention be paid to distribution, necessitating action by the manager of distribution in Musgrave's framework. While these aspects have received

considerable study, as noted earlier, relatively less attention has been paid to the failures of government or of the nonmarket mechanism. More recently, however, as a part of the public choice school, studies were initiated in this regard.29 The theory expressed in these studies of nonmarket failures stresses that information acquisition and its control, bureaucratic inertia, and the tendency to self-preservation may contribute to the increase of redundant costs over time and to a sustained growth in public expenditures. The measurement of the costs would be possible only when there are organizational goals (formulated on a viable basis) that act as proxies for nonmarket output. Moreover, the state may create unanticipated effects through its regulatory policies. In respect of distribution, it may create more inequalities when its pay or pension policies for certain classes are indexed to income while some others are not. Correctives for these nonmarket failures will be possible only when there is a keen public awareness of the issues and a reliable system for correction both within and outside government. These views supplement the three-branch approach of Musgrave by illustrating the need for both policy and informational correctives in budgeting. If, in the Musgrave framework, a tranquil functioning of the government is assumed within the framework of given concerns for both distribution and stabilization, the theory of nonmarket failure stresses the need for correctives in a dynamic setting.

The preceding analysis indicates that, while substantial progress has been made in the study of public expenditures, the theories explain at best only selected aspects and are far from operational. In practice, therefore, budgeting tends to be a political and bureaucratic process that takes into account the economic factors. In some situations, it becomes an economic process that fully recognizes the political and associated factors. Therefore, it remains an art and is not yet a science.

**INCIDENCE OF PUBLIC EXPENDITURES**

The budgeteer is confronted with a number of issues in determining allocations among programs within each budget function. While political influences are always present, the policymaker would like to

29For a summary of the views, see Charles Wolf, Jr. (1979), pp. 114–33.
be informed on the direction, the benefits, and the community’s acceptance and utilization of expenditures. His concerns can be analyzed under two complementary groups. From a macroeconomic point of view, the distributive aspects of government expenditures are of considerable importance because they have gained further impetus during recent years with emphasis on the use of public expenditure for providing basic needs, ameliorating the lot of the poor, and improving the delivery systems of public services. There is also an implicit link (irrespective of one’s preference for the benefit, the voluntary exchange, or the ability-to-pay theory of taxation) between the community’s willingness to pay taxes in compliance with the tax system and the quantity, quality, and cost of public services. From a program management point of view, and for purposes of budgeting, the policymaker’s interest lies in ascertaining the clientele to use the services, the location of the clientele, the amount of use of services, adequacy of the services, and sufficiency of the resources, as well as monitoring the cost movements. Evaluation of benefits is also useful in undertaking ex ante cost-benefit assessments of new expenditure programs. Alternatives to existing programs can be envisaged if, for example, the target groups of expenditures (backward regions or low-income classes) are not receiving the benefits. The concern is then to seek answers regarding the fulfillment of the government’s policy objectives.

In providing answers, the policymaker can resort to two broad instruments—managerial techniques and economic studies. The former refers to cost measurements, efficiency assessment, and the overall evaluation of performance in terms of the primary objectives of programs or with reference to objective criteria. These aspects, which form part of performance budgeting, are considered in some detail in Chapter 11. These techniques are also frequently supplemented by a performance or effectiveness audit that is carried out by independent audit agencies on behalf of the legislature. The focus here is limited to the economic studies that may provide some useful guidance to the policymaker in the above areas.

Expenditures cover a wide area, and their incidence and effects are similarly far-reaching. The economic effects of expenditures are examined with reference to the primary effects of spending itself, the secondary effects of consumer spending when consumers begin to spend their newly earned income, and the tertiary effects of new
The study of expenditure incidence involves an analysis of the adjustments made in the private sector's economic behavior as a result of the provision of government services. The incidence itself is a vastly complicated phenomenon, and its assessment must take into account the interdependent relationships between public and private sectors and the difficulties in isolating the effects of expenditure. The household's recognition of and reaction to the government's services depends on its perception of the services and the extent to which they are internalized. Both these differ, depending on the purpose and category of expenditures. To recall the earlier classification of expenditures, the government budget consists of public goods and quasi-public goods, direct trading and manufacturing activities, transfers to productive sectors, and transfers to households. Of these, the benefits that flow from direct trading and manufacturing activities are evident in a straightforward manner because these are traded in the market. The pricing mechanism indicates the movements in consumer welfare. Transfers to households, comprising pensions and other social assistance benefits, lend themselves to some measurement in the first stage of incidence. More or less the same is true of transfers to productive sectors, where the effects would become evident from the market signals. The more complex and somewhat intractable area relates to the public and quasi-public goods. Most of the recent studies
of expenditure incidence have been addressed to this area. The general assumption behind all these studies, although not explicitly stated, is that the budget is comprehensive and that all relevant expenditures pertaining to a function are incurred only through the government budget.

The several statistical analyses that have been made can be conveniently grouped into two broad categories—benefit and income approaches. The benefit approaches essentially seek to estimate the benefits from government expenditure and to distribute them among different groups according to the researcher’s preference. As there is no market mechanism that effectively reflects the value of government services, the costs of production—or government outlays—are taken as the base and apportioned to different economic groups. Among the groups that have been examined are rural versus urban, poor versus nonpoor, low-income and high-income groups, regional groups, and general versus specific expenditures. These studies reflect several problems; the assumption made on the valuation of government services is itself the main handicap, and the studies do not attempt to examine whether services are substandard or whether the benefits are greater or less than the expenditures. The income approach, or the money flow approach, concentrates on the recipients of direct payments made by government on the assumption that expenditures benefit the people who receive the payments. There are also variations on this theme. In some cases the distribution of expenditure is assumed to be congruent with income groups, and tax and expenditure burdens are distributed according to that pattern. The argument against the tax approach is its concern with the recipient and not with his work, and the limitation of the expenditure approach is that it deals with the total expenditure (and, therefore, excludes the impact of specific expenditures) and does not lend itself to empirical testing. A further variant is to measure the costs of selected programs and to treat them directly as proxies for the value of benefits and then measure the actual costs across the various groups of income, with focus on distribution of

30 For a review of the literature, see Luc De Wulf (1975), pp. 61–131. His survey refers to a third approach, which examines how the transfer of resources from the private to the public sector modifies the expenditure pattern in the economy and affects factors and outputs that are more appropriately a part of budget incidence studies not covered here. Also see J. Meerman (1979), Ch. 2: A Model of Budget Incidence; M. Selowsky (1979); and A. P. Gupta (1980).
the services. This approach involves heroic statistical assumptions and has some fundamental limitations in that the analysis is confined to a few sectors and excludes outlays on public goods. As a further variation, a radical theory of fiscal incidence has recently been proposed, but its distinction lies not in seeking a measurement of benefits but in analyzing the nature of the state and it implies that all expenditures have the aim of protecting the interests of the capitalist class.\(^{31}\)

The cursory discussion above of these approaches illustrates the difficulties in providing answers to the policymaker’s needs. Some of the studies are characterized by inherent statistical limitations and other features that reduce the acceptability of the approaches presented. From a statistical point of view, they cover a limited time span (one year), are not able to distinguish the effects of cumulative and current outlays, are aggregative in nature, and reflect a static situation rather than development over time. Their classifications of expenditures do not conform to the decision-making packages of the policymaker, and the studies do not answer the policymaker’s concerns of seeking new directions for existing services or for the provision of new services. Also, because of the diversity of approaches, the same data could be used to arrive at different conclusions. As some of the studies have excluded major public outlays, such as defense, they have also implicitly ignored the interaction among groups of expenditures. It is not unusual to find that the distributional intent of some expenditures may be overshadowed or neutralized by other expenditures. Thus, the exclusion of externalities continues to be a major problem. Moreover, some studies ignore the relationship between inputs and outputs. The research studies, as one investigator described it, should be considered to be on a more modest scale than is implied by their titles. To revert to the concern of the policymaker, it appears that his job has not been made any easier by recent research. His intuitive perception of the needs, and his reliance on administrative techniques of performance measurement, on the one hand, and the voters’ preferences revealed through democratic procedures, on the other, continue to mold expenditure programs.

\(^{31}\)See D. M. Peppard (1976), pp. 1–16.
The art of budgeting consists of several ingredients and this chapter is devoted to a discussion of the current state of the art, its problems and prospects. The chapter, therefore, covers a wide area. It considers first the scope of the budget, its boundaries and tasks, followed by a discussion of the practical determinants of expenditures and revenues, approaches to their inclusion in the budget, and the nature and role of various constraints. It concludes with a description of the nature of the impact of the budget on the economy and the techniques in use for assessing it.

**Scope of Government Budget**

The scope of the government budget has been a source of debate over the years. With the spread of government activities and the growth of multilevel decision making, on the one hand, and the emergence of earmarking and debudgetization aimed at reducing the uncertainty from the legislative overview, on the other, the debate has gained added importance. Determination of the scope of the budget is dependent on the scope of government and on the purposes of the budget. Both have exerted strong influences on the shape of the government budget.
Governments are classified, for purposes of national accounts, into central government and general government. The former essentially comprises the departments and agencies at the central level, while the latter consists of all units at the central, provincial, regional, state, local, municipal, county, and village levels. Two aspects of government organization, however, have proved somewhat difficult. How should nonprofit organizations and public enterprises be treated? The area of public enterprises is a complex one with some definitional problems and is treated in some detail in Chapter 14. For brevity of discussion, however, these are units that are either owned or controlled by government, that may be organized as a part of government budget or outside it, that may have a corporate, statutory, or company form, and that are engaged in the production or sale of goods and services to the public. Nonprofit institutions are those that engage in quasi-governmental activities and are largely funded by government. They have a separate organizational entity. Both these types of organizations generally have their own budgets and specified means of legislative accountability. Government budget transactions in this regard are normally restricted to transfers to and from government.

An enlarged definition of government, seeking to reflect all the financial decision-making centers, is provided in the term “public sector.” Although the definition is not free from ambiguity and there is a likelihood of numerous borderline cases, the public sector consists of (a) producers of government services—government departments and ministries, social security schemes, and nonprofit institutions; (b) departmental enterprises organized as a part of the government budget and engaged in the production and sale of goods and services to the public; (c) nonfinancial public enterprises engaged in the production and sale of goods and services and having budgets of their own; and (d) public financial institutions, including central banks, commercial banks, and insurance institutions. (Of these, treatment of social security systems is considered separately.) Although the scope of the definition is comprehensive, administrative problems arise in setting criteria for the inclusion of nonprofit institutions in the public sector. The framers of the United Nations’ A System of National Accounts

1 General government is a concept used in national accounts and is distinct from the more technical use of the term in government budget where it is used as a synonym for General Account. See also Chapter 13.
recommended that the criteria should be (a) whether the institution has a function that the government would otherwise have carried itself, and (b) whether more than half of its expenditures are financed on a continuing basis by government. It is generally recognized that difficulties arise in determining whether government would have assumed the functions of nonprofit institutions or is merely giving help to an essentially private group activity. The financial criterion also bristles with problems, in that government provision of half of the nonprofit institution’s resources would make it governmental and inclusion of such institutions in the public sector may defeat the purposes for which they were set up. Another practical problem is that these bodies may be too numerous to permit economical data collection and, in most cases, their overall impact on financial decision making may be trivial. The scope of the public sector would change from time to time, if, owing to resource stringency, financing by government is reduced to less than half of the total requirements of the nonprofit institution. The concept of the public sector is therefore dynamic and changes over time.

**Budget Boundaries**

The issue is raised whether the government budget should be comprehensive and should include all levels of operations funded by it. Those who seek an expansion in the government budget argue in terms of the need for comprehensiveness for purposes of technical competence and for purposes of better decision making. (For this purpose the issue of earmarking is isolated and considered in Chapter 5.) It is argued, for example, that a government budget should include all important information on public sector transactions and that a unified budget would provide the decision makers and budget administrators with a comprehensive picture of public sector transactions.² Similarly, it is suggested that the exclusion of the operations at subordinate levels of government from the central budget reduces its comprehensiveness and, more significantly, tends to reduce its capacity to implement public sector development programs.³

In considering the validity of these criticisms, a distinction needs to be made between the formal, legal, and legislative purposes of government budget and its overall policy function. It is not, however, the intention here to suggest that there are conflicts between the two functions but to suggest that they may be served in different ways. In meeting the legal purposes, the government budget will have to confine itself to its own juridical entity and cannot extend to other levels such as the state governments and public enterprises, which have their own juridical functions. Legal purposes have an overwhelming influence in the determination of the boundaries of government budget and must be given their due weight. Where extensive legal separations have been made at one level of government in the form of autonomous entities, as is the case in several Latin American countries, an appropriate alternative would be to seek remedies at a legal level through the abolition of entities that reduce the effectiveness of government budget. Caution also needs to be exercised to ensure that the budget is not full of superfluous transactions and needless complexity. For purposes of policy, however, the legal and formal considerations can be ignored and supplementary mechanisms can be adopted for establishing the degree of comprehensiveness needed for the budget. Toward this end, Latin American countries evolved, during the early 1950s, a national economic budget, consisting of the economic, financial, natural, and human resources of the country. With the adoption of formal planning, this purpose was served by the development plans. Later, from the mid-1960s, medium-term public expenditure forecasts undertaken by governments, took into account the transactions of regional and local governments, as well as the operations of public enterprises. Econometric models employed for buttressing policy analysis have used the data so generated for achieving a better understanding of the impact of the budget on the economy. While the supplementary efforts are not yet as well refined as they ought to be, it appears that these pragmatic approaches have proved useful in establishing an overview of public sector operations, thus minimizing the resort to legal mechanisms.

**Budgeting in Practice**

Although budgets are for specific financial years, in practice budgeting is continuous and is so undertaken in the spending agencies.
and in the ministries of finance or planning. Budgeting involves the interplay of several forces and, to gain a proper perspective, may be distinguished from expenditure controls. The distinction may in some sense be arbitrary, but it is useful. Budgeting is viewed here in a wider connotation to deal with institutional factors, recognition of economic environment, formulation of relevant policies, patterns of legal accountability, and responsibilities of the central and spending agencies. Expenditure controls, which are much narrower, refer to techniques that are utilized at selected stages of budgeting for the review of programs and their financial estimates and, at a later stage, for ensuring that the formulated budget estimates are adhered to in practice.

Budgeting involves different tasks on the expenditure and revenue sides. On the expenditure front, it involves the determination of the total size of the budget, size of the outlays on different functions, and the magnitude of outlays on various programs that are part of a function. On the receipts side, the size of the overall revenues and foreign aid, where applicable, needs to be decided. A decision is also needed on the size of the deficit, components of its financing, and the likely ownership of public debt.

These tasks are common to all countries, irrespective of their political ideology, economic status, experience as an independent country, or level of moral responsibility. Moreover, all of them require an explicit recognition of the policy parameters discussed in Chapter 1.

The three functions of the modern budget—allocation, stabilization, and distribution—imply the need for making a budget through a budgetary process, comprising the five stages shown in Chart 1. The components and tasks involved and described therein may be examined here in terms of their economic aspects and the administrative steps to be taken.

4Writing in 1956, Jesse Burkhead observed that the nature of budgeting and related problems is different in developing countries, for "there is a shortage of accounting and administrative skills; there are gaps in the administrative organization; there is an inadequate sense of moral responsibility for the conduct of government affairs" (Burkhead, 1956, p. 455). Some of these are common, although in varying degrees, also in industrial countries. In any event, it is difficult to measure the adequacy of moral responsibility of a government.
BUDGETARY TASKS: ECONOMIC

From an economic point of view, the budgetary process implies that concerns of allocative efficiency, stabilization, and distribution are given due consideration at each stage. Allocative efficiency, as noted previously, consists of the allocation of resources between the public and the private sectors, resource allocation among competing demands within government, and assessment of the trade-off between allocational and other objectives. Performance of these subfunctions requires assignment of weights to the various objectives, methods for ascertaining collective preference, formulation of judgments on the broad relations between the public and private sectors and on how the proposed revenues, expenditures, and financing would affect them, and—in the light of that analysis—allocation of the resources to the agencies of government. In making the allocation, the budget agency is ideally expected to balance the marginal losses of welfare to the community from tax payments against the marginal gains from public expenditures and to ensure that the marginal benefits from each monetary unit of expenditure within government are the same. In practice, as there is no single way in which such a review can be done, reliance must be placed on proxies, intuitions, and other substitutes for market signals.5

The stabilization function requires a more precise assessment of the economic impact of government operations on the economy and a consequent adjustment in the budget. Over a period of years, a number of concepts and techniques have come to be used for the purpose. Reliance on national accounts, utilization of forecasting techniques, and closer coordination with monetary authorities are a few examples. As an integral part of this effort, contingency plans need to be formulated to provide for increases or reductions in taxes and expenditures to meet sudden or unforeseen changes in the economy. More stringent plans for controlling expenditures would be needed if the budget is to achieve a specified degree of restraint or a specific stimulus in the economy. If controls are slack and if government spending increases at a rate higher than scheduled, or if tax collections

5In some cases, it is very difficult to determine the market prices of resources. Niskanen cites the electromagnetic frequency spectrum and the air space as two areas for which no user fees are paid and for which no prices exist either within the government or the private sector (Niskanen, 1973, p. 35).
are less than expected, then restraint or stimulus cannot itself be controlled with any precision and the budget will become a destabilizing factor.

Distributional imperatives require attention to the incidence of public expenditures and the income groups that are expected to be served. Alternatives such as cash payments in lieu of services may have to be envisaged, or programs may have to be redesigned to meet the needs of specified income groups. In endeavoring to meet these objectives, conflicts of an economic and administrative nature arise. What is the ideal distribution for the public and private sectors? What is the optimal distribution among competing demands in government? What is the trade-off between allocation and stabilization and between stabilization and distribution? Answers to these questions are not easy. They constitute the hard core of public policy. It is also not expected that formulation of policies in these spheres is the exclusive responsibility of the budget office. It is inherent in the budget process that distributional concerns would be the primary responsibility of the administrative or spending agencies and that the responsibility of the finance and planning agencies would lie more in the allocation and stabilization functions. The fiscal responsibility is a joint one that covers the whole range of government. The perception of the spending agencies is, however, likely to be different from those of central agencies in regard to allocation and stabilization functions, in that their awareness of the resource realities and the issues in economic management will be less than has been assumed, or at any rate less than that of central agencies. Budgeting requires as a precondition that there is adequate communication on these matters during the process of the determination of annual budgets or medium-term financial plans.

Experience suggests that there are practical difficulties in bringing the influence of these three concerns on budgeting simultaneously. Countries that have formulated development plans appear to have paid more attention to allocative aspects and less attention to distributional concerns. Although it has been recognized in several countries that the financing of plans through money creation would be inflationary, the impact of such financing on allocation and stabilization did not appear to have been given due importance. Later, with the emergence of inflation as a major problem, greater attention was devoted to the stabilization function at some expense to considerations of allocation.
and distribution. The persistent occurrence of these problems implies a policy gap as well as an institutional one. The direction for the improvement of the budgetary process lies in minimizing the ad hoc approaches and in providing an integrated outlook. It is tautological to say (although this is not often recognized) that an effective fiscal policy requires an effective budgetary process that integrates the economic, financial, and program analyses as a feature. Ideally, economic analysis should include long-range fiscal plans, establishment of resource needs, formulation of alternative fiscal strategies, assessment of the proposed budget's impact, and planning of tax and expenditure adjustments. Financial analysis should consist of the evaluation of competing demands within each function and their contribution to the allocation and stabilization purposes. Program analysis comprises detailed analysis of program needs, incidence of expenditures and benefits, analysis of service standards, estimates of the volume of activities, phasing of outlays, and the guarantee of an adequate allocation of resources.

An important task of budgetary policy is also to promote growth. It can be accelerated through additional expenditures in desired sectors either through direct outlays or through an appropriate strategy of development of infrastructure that, in turn, will induce further investment. Tax incentives and the provision of credit, depending on their need, direction, and structure, play a useful role in promoting economic growth. Implementation of a strategy of growth is reflected in the allocation of budgetary resources to those sectors whose projects and programs have been reviewed and are considered to have an impact on growth. Such a strategy is an integral part of an agricultural, industrial, or transportation policy rather than the mainstream of fiscal policy. The importance of the latter consists of ensuring that the resource realities and the impact of the proposed outlays on the economy are fully taken into account. Specifically, the budgetary tasks in a growth context involve a financial and economic review of the outlays and an assessment of the impact of growth on future expenditures and revenues. These aspects merit detailed consideration in the formulation of medium-term strategies and in the annual budget.

The determination of the actual tasks at any given stage will involve conflicts and trade-offs. In an ideal situation, with the availability of full information and reasonable control on exogenous factors, it would
be expected that the budgetary process would be so organized as to permit a simultaneous determination of all major budget questions. In reality, such complete control is not feasible. With that aim, however, the process is organized as an iterative one with sequential steps. Being iterative could itself contribute to a potential problem, in that conclusions that are independent of the sequence may be reached or may depend heavily on the sequential procedure adopted. Problem-solving approaches generally refer to simultaneous scanning or selective scanning. Although a simultaneous scanning of issues and their interrelationships is frequently aimed at, because of the numerous issues and time constraints, in practice only selective focusing may be achieved. Such selective scanning is not a goal but a convenient rule of thumb of the administrator when other methods prove difficult to apply.

DETERMINATION OF PUBLIC EXPENDITURES

The budgetary process is only a conduit for the identification of the parameters that influence decisions on the magnitude of expenditures. Primary concerns at this stage are the allocative efficiency of resources between public and private sectors and among the various services within government. Determination of total expenditure takes place in two ways. In a model of devolution, such totals would be decided by the central finance or planning agency and communicated to all other agencies. In an aggregative model, the individual expenditure requirements of each program would be compiled and then consolidated. A combination of these two approaches is found in practice. Central agencies that are charged with fiscal management need to determine the appropriate level of expenditure in the light of the resources available and the permissible levels of deficit. These initial levels of expenditure are usually notional and are used as a basis for discussion with spending agencies. By their very nature, these notional magnitudes cannot cover the millions of government programs in detail and they are considered, with some justification, as tentative benchmarks. Viewed thus, the normal limits of expenditure may be determined in the following manner:

\[(\text{Revenues}) + (\text{Deficit}) = (\text{Total government expenditure})\]

This equation will have different emphasis in countries that are
traditionally dependent on foreign aid. In such cases \((\text{Revenues}) + (\text{Foreign aid}) + (\text{Deficit}) = (\text{Total government expenditure})\). In countries that have annual surpluses in the government budget such as countries that are members of the Organization of Petroleum Exporting Countries (OPEC), or in contexts where surpluses are aimed at as a matter of policy, it will be \((\text{Revenues}) - (\text{Surplus}) = (\text{Total expenditure})\). Thus, even if only aggregative expenditures are to be adopted for purposes of initial budget compilation, they will have to be adjusted to available revenues and permissible levels of deficit.

There are other variations of this approach. For example, it is argued, based on the experience of the United States, that the major determinants of public expenditure are estimates of total revenue and the desired level of defense spending. Revenues and deficits are considered as economic policy instruments, and nondefense expenditures are thought of as a remainder after defense needs are attended to.\(^6\)

Such broad groupings of expenditure may and do facilitate political preferences in some countries. On an analogous basis, it could be argued that, in developing countries, the primary determinant of expenditure is the share of development expenditure, with non-development expenditures treated as a remainder. In reality, however, such dichotomous approaches do not appear to be prevalent in developing countries and, in any event, may reflect some oversimplification of the actual process.\(^7\)

In a context where most countries have development plans or medium-range and long-range expenditure forecasts, it cannot be said that any single division of expenditure would be the major determinant of the budget. In wartime, however, it is almost certain that defense expenditures would be the major item in the budget, and the dimensions of defense spending would depend on the outlook for war.

The determinants of expenditure in the day-to-day world may be classified into endogenous and exogenous factors. For this purpose, the government as a whole is treated as a single homogeneous entity. It is to be noted that within government an endogenous factor to some may


\(^7\)Also, to the extent that outlays on defense or development are reduced as a proportion of the budget, their importance will also decline. In some countries, current expenditures may be viewed as the major determinant of the budget, with investment expenditures being a sort of residual.
be viewed as an exogenous one. Endogenous factors comprise continuing outlays reflecting expenditure from recent or previous legislation and costs of services. Approved policy goals and organizational capabilities are a part of this group. Exogenous factors include policy revisions reflecting changed conditions, growth of population and changing patterns of clientele, technology of services, price factors, and, above all, the resource availability factor. In addition to these tangible factors, there may be some environmental ones that may influence the pattern and growth of expenditures. For example, it is the general belief that there is an innate urge in the government to spend more and that the desire to do good is endless in government. The custom of upholding prestige or related hedonic preferences may also be at work, and they may collectively work from within to contribute to increased expenditures. Externally, greater availability of resources, particularly through inflation-induced taxation, could lead to increased spending. Further, a resort to deficit financing could in itself induce a rapid increase in government spending. Some of these assertions are debatable. Whether increased needs lead to higher mobilization of resources or whether the latter would induce the former is an ontological question, and categorical answers are hard to find. The absence of an immediate resource constraint does not in itself induce expenditures when they may have to be stabilized in the light of other major economic constraints. Final levels of expenditures are, therefore, the result of several complex forces at work, and attribution of these forces to any single factor could be misleading.

**Expenditure Estimates: Preliminary Considerations**

Formulation of a budget involves making a forecast of the next year's requirements. Informal and preliminary forecasts undertaken by the spending and central agencies are useful in charting their requirements and needs. Usually the forecasts take into account (a) continuing needs for which commitments were made on a long-term basis, (b) changes in the costs of these services, (c) announcements of new expenditures or legislation affecting the expenditures enacted during the year, (d) share of outlays for continuing projects, and (e) outlays on new projects or programs. Such estimates will also take into account any decisions made during the year to wind up or abandon some government
activities. The important aspect for decision making is the determination of the new outlays, their magnitude and allocation pattern, and changes in the outlays for continuing activities, involving reallocation of those margins to others and determination of their requirements during the year. The estimates also take into account the previous relationships between estimates and the actual expenditures, performance ratios and factors contributing to their variations, and commitments made during previous years but requiring cash payments during the current year. These estimates are routinely compiled by the administrative agencies and the finance ministry.

The allocation of expenditures among programs is determined through the normal decision process used by administration. The process is characterized by the application of convenient rules of thumb, cost-benefit or feasibility studies for new projects, and bargaining. The extent to which one or all of these are utilized varies with the nature of the expenditure and the administrative system. Traditionally, British and Commonwealth systems distinguish between continuing charges and new services. Continuing charges include "consolidated" or "nonvoted" expenditures reflecting the salaries of the heads of government, judiciary, and other units that have no defined cut-off period and that are not subject to undue variation. Other charges, such as interest payments, are also included.

8 The estimates are to be treated as instruments of overall budget policy and should have some flexibility. To that extent, analysis of aggregate estimates to establish linear relationships between legislative and executive branches or the pattern of allocations for agencies to predict budget outcomes, or to postulate models for describing the aggregate budgeting process of a government may have certain limitations. Studies made by Davis, Dempster, and Wildavsky have offered some explanation (see Byrne, 1971, pp. 292-375) of these relationships but in the process have tended to assume typical behavior for executives and legislators. Sensible executives are always responsive to legislative needs, for they are expected to reflect collective preferences of the community. This behavior is, however, contingent on the merits of the program and the general financial situation. The analysis in these studies is too aggregative and excludes consideration of the revenue position and its impact on estimates. Budgets are seen merely as compilations of expenditure proposals, with no foundation in economic purpose. The main limitation of the approach by Davis, Dempster, and Wildavsky is the implication that determination of agency requests is always done in terms of previous experience rather than a useful rule of thumb resorted to in the preliminary stages of an iterative process. Models and statistical studies are obviously more useful when exogenous factors are taken into account.

9 The system of continuing charges occasionally leads to misleading practices. In some cases, military expenditures are included in the expenses of the President.
in continuing charges. New services or new items represent proposed outlays on policies that have not yet received the approval of the legislature. In a similar fashion, French budgets make a distinction between services votés (continuing charges) and mesures nouvelles (new measures)—which can be both positive or negative. In countries that have formal development plans, new projects are, with only a few exceptions, drawn from the current plan. If the purview of the plan is, however, limited to capital projects or outlays of an investment type, new measures will cover current or routine activities. Plan projects, in theory, are expected to have been subjected to an investment appraisal and it is therefore assumed that their allocative efficiency has received due attention. Appraisal of new projects cannot include a comparison of their merits over the wide spectrum of functions but such a comparison may be undertaken within a function.

It is believed that, since a large part of annual outlays are for continuing projects, the attention of the budgetary process is focused only on marginal additions. In practice, however, marginal changes occur even within continuing outlays. Changes in the existing outlays, as well as marginal additions, receive the same attention and pass through the same administrative process. If the marginal addition is important to an agency that is already assured of its continuing outlays, retention of some of the existing allocations may also be important for another agency. In either event, the forces at work for obtaining allocations are the same. Given the tight time schedule for the budget, only a scanning may be possible for some new proposals. Those that have already been accepted in principle or have been included in the development plan may receive only a financial review in terms of the accuracy of estimates, while totally new proposals are likely to be subjected to economic, financial, and program analyses.

The task of formulating estimates of expenditure for the next year tends to be easier when a medium-term expenditure forecast is available. Given such forecasts, the task for the annual budget is to adjust for exogenous factors, such as changes in economic climate (which may involve more or less subsidies or public works outlays), changes in cost factors (rate of inflation), or changes in demographic profiles (e.g., net additions to the number of pensioners could entail more pension payments). Attention could then be focused on new

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10This approach known as incrementalism is considered in detail in Chapter 4.
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proposals. In the absence of such medium-term expenditure forecasts, the above factors would need to be given detailed consideration in the expenditure estimates, involving a deeper probe into the expenditure categories. For personnel expenditures, the net additional posts created, the gap in filling them, and the consequential savings, if any, would be important. Similarly, projects that are usually included in a capital budget need more attention. Performance during previous years, availability of materials for the next year, and the likely emergence of bottlenecks and their impact on the pace of construction would need to be reviewed. Experience of industrial and developing countries alike indicates that current expenditures are usually underestimated, while capital outlays are overestimated. The latter may in part be due to the visibility attached to capital projects and, in developing countries, a number of projects may be included with a view to obtaining more foreign aid.

Annual estimates for capital projects must take into account the nature of the budget provision. In countries that have an obligation-based budgetary system, all funds necessary for the life of the project may need to be shown in the budget. Supplementing such a presentation, data on annual cash outlays are provided separately. In the British and Commonwealth systems, two practices are followed. A token provision may be made in the estimates to obtain legislative approval. This provision implies that supplementary estimates indicating the actual amounts needed would be submitted later. Alternatively, funds are appropriated annually, signifying the project outlays for that year. In the latter case, supplementary information delineating the full costs of the project may be provided. In the French system, a distinction is made between autorisation de programme, which constitutes the upper limit of funds that ministries can commit for projects, and crédit de paiement, representing payments that can be made in any year under the approved authorization.

Annual expenditure estimates must pay particular attention to two other elements whose importance has grown considerably in recent years: (1) government lending operations, and (2) the spillover of the effects of operations of revolving funds and trading accounts. A cursory analysis of government operations indicates that lending to government agencies and to the public has been growing. In developing countries, such growth in transactions partly reflects the international borrowing channeled through government budgets. The lending
operations imply that the social and economic purposes of government are carried out by autonomous or other agencies and that their activities are financed by loans. Annual estimates for these need the same attention as other estimates. Decision making on loans is different from other decisions in that it is not restricted to marginal adjustments but revolves around the old as well as new loans, and final decisions are based on the capital market conditions and the purposes of lending. Specific attention would be needed for the estimation of the element of subsidy involved in lending.

Revolving funds, which were originally restricted to trading operations and are expected to be self-financing, have exceeded their original intentions. They are now widely used and have often ceased to be self-financing. Government trading activities, particularly in the procurement and distribution of foodgrains, have expanded significantly in a number of countries. As they are vastly undercapitalized, their deficits become a charge on the general budget. If such activities are not anticipated, they could change the budget outcome significantly. Estimates of trading activities imply detailed calculations of prices and quantities, which can be complex in a fast-changing commodity environment. These factors underline the need for greater care and comprehensiveness in the formulation of expenditure estimates.

Revenue Estimation

Revenue estimation can be viewed in terms of the formulation of both the immediate year’s estimates and those over the medium term. The latter aspect is considered in Chapter 6.

Estimates of revenues for the following year must be made before expenditure ceilings can be conveyed to spending agencies. Preliminary estimates, which are based on existing taxation may change over time and, eventually, as the final estimates of proposed expenditures emerge, it may be necessary to take discretionary measures for mobilizing additional revenues if the level of deficit is to be maintained or curtailed. Revenues and levels of deficit represent the policy variables that, as shown above, determine the broad level of expenditures. Revenue estimates facilitate the consideration of expenditure policy options and therefore are to be formulated with care. Each expenditure program cannot be viewed against revenues except

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for expenditures financed from earmarked funds. The aggregate expenditures are determined in that light, and in the iterative process adjustments are made in expenditures to be within the revenue limits.

Revenue estimates for the next year are formulated in two ways. First, an accounting approach of forecasting receipts, based on the rate of growth recorded in previous years, may be adopted for each major source of revenue. In this exercise, a distinction is made between autonomous growth and the yield from discretionary measures. Buoyancy, reflecting the overall growth of taxes, and elasticity, representing the effects of discretionary action, are calculated and forecasts made. The approach, however, has limitations in that the relationships with the rest of the economy are not explicitly recognized and are taken as a part of the rate of growth of previous years. Second, a more organized approach is to provide for an explicit recognition of national economic parameters, including the likely increase in GNP, the rate of inflation, and the impact of increased government expenditure on taxation. Specific variables can be introduced, depending on the revenue structure, to reflect the activities of major sectors, such as international trade. In countries which derive most of their revenues from the sale of a few commodities, such as minerals and oil, revenue estimation may be less complex. In such cases, production and price schedules of the commodities shape the revenues. In other export economies, particularly where agricultural products dominate and where foreign markets have been volatile, estimation of revenues is more complex. In a number of developing countries, foreign aid, as noted earlier, is an important part of the revenue, sometimes constituting more than a fourth of total receipts. Estimation of foreign aid has generally proved difficult and is dependent, among other things, on intangible factors, such as political approaches.

Experience with revenue estimates reveals that organizational and attitudinal factors have generally impeded the usefulness of revenue forecasts. Organizationally, revenues are estimated by agencies that are responsible for revenue collection and thus are conservative, partly because of a desire to show a better actual performance. Such conservative estimates are also preferred by the budgeteer, as they provide a margin when higher expenditures must be financed during the course of the year. Conservative estimates also encourage the spending agencies to believe that revenues will cover expenditures. In some countries, revenue estimation is carried out crudely, without
adequate attention to the impact of government expenditures on taxation or the feedback effects of previous changes in taxation. In a few countries, the distance between the revenue and budget agencies is a real and physical one. Estimates are often provided at too late a stage to permit an appraisal of expenditures. In some cases, the revenue estimates are formulated, processed, and printed without the consideration of expenditures.

Revenue estimation, if it is to be a meaningful input to the budget, must be better organized and better integrated into the budget cycle. Also, to protect against undue volatility and a consequent rush in expenditure adjustments, revenues must be planned on varying assumptions. Just as expenditures are planned in a zero-base budget system on different assumptions of resource availability, revenue forecasts—including foreign aid—could similarly be formulated on different assumptions. In undertaking such estimation, a reciprocal adjustment is made between expenditures and revenues. From the expenditure side, revenues may be assumed to be as given, and plans may be formulated either for expenditure adjustment or for further discretionary revenue measures. From the revenue side, the level of expenditures could be assumed, and different packages of additional revenues could be formulated. Additions to revenue may accrue from several sources—new measures, improved tax collection, and enforcement being among the options available to decision makers. Given that each new tax has an effect on production and consumption, formulation of different packages provides an opportunity to assess the merits of each package.

**Aggregative and Devolution Styles**

Budgeting, as an iterative process, involves a two-way movement—information moving from agencies to the center (aggregative approach) and from the center to field agencies (devolutionary approach). An ideal situation would demand an appropriate combination of these approaches. In practice, only one would appear to be followed, with each situation contributing to avoidable problems. Although some problems have been mitigated with the adoption of medium-term

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11See Chapter 11.
expenditure planning, many still persist, particularly in countries where no detailed expenditure planning is undertaken.

Under the aggregative approach, each agency and enterprise acts as an independent decision-making unit. Its primary motive, which is partly aggravated by a lack of awareness of resource constraint, is to obtain as high an allocation of resources as possible. Amounts equivalent to the current year's budget are viewed as "floors," and a shopping list of projects and programs that are still at an early stage may be included. Part of this attitude stems from viewing the size of the budget allocation as a measure of power and part from viewing unkindly efforts at saving money or making only minimal demands for allocations. In such a context, the proposals of the spending agencies are reviewed and consolidated with reference to ad hoc benchmarks before the budget is formulated. Admittedly, this procedure, which is in vogue in several developing and some industrial countries, has contributed to problems over the years. First, in the absence of policy guidance, expenditure programs are often ill-judged and poorly timed. Objectives of government then tend to depend on the budgetary outcome rather than being a starting point for the formulation of programs. This also leads to problems in what the Plowden Committee called the "indeterminate area between policy and administration." Alternatives to government expenditures may not be explored, and expenditures may continue to be incurred even after the original objective has ceased to be meaningful. By the same token, the allocative, stabilization, and distributional concerns of government remain unfulfilled, as the budget is not specifically used for those purposes. Second, the whole process of budgeting becomes negative because the central agencies spend their time in pruning what they consider to be "padded" estimates. When budgets are formulated by agencies to meet external constraints, a great deal of doctoring of expenditure estimates takes place. Experiences of this type are to be found in everyday life in the transactions between subordinate agencies and administrative ministries, between administrative ministries and finance, between local and central governments, and—in a federal

Leslie Chapman says that any civil servant who is bent on saving will find that he has few friends and that he naturally adopts a "play for safety" philosophy (Chapman, 1979), p. 55.

setup—between state and central governments. Inevitably, the budgetary process, which has the positive purpose of allocation of the funds, and building up a partnership for economic management, leads to incessant administrative wrangling. Exaggerated caricatures of officials involved ("inverted unsmiling macabres sitting in the Treasury with scalpels ready") and the continuous search to shift the blame for failure are a consequence of this approach. Review in such circumstances may focus on minute and trivial details, reflecting a triumph of technique over purpose. More significantly, such attempts at control may be viewed as substitutes for good budgeting and, as the final budgets may not reflect the actual requirements, correctives must be introduced throughout the budget year. Thus, the far-reaching effects of this approach permeate the entire government.

The alternative to the aggregative approach is the devolutionary approach, which should not be viewed as a statutory process of distributing the proceeds to those who are entitled to them. Rather, it is viewed as a process where a central agency undertakes advance planning for the requirements of the government and indicates what these are to the spending agencies as initial ceilings for their budget. Inevitably, details of such an exercise pose problems. Detailed enumeration of projects and programs is, in any administrative context, the responsibility of the administrative agencies. The task of the central agency in formulating and indicating the amounts likely to become available is to promote awareness of resource realities, priority planning, and a more coherent relationship between objectives and programs. The purpose of the process is to ensure a firm bridge between intentions and actions. The quality of indications is dependent on the capability of the organization to look forward and on its own unbiased formulation of estimates.

In practice, however, the working of indicative or devolutionary methods has not been as successful as expected. This is due partly to attitudinal factors and partly to difficulties in estimation. Attitudinal factors involve the tendencies on the part of the finance and planning agencies to formulate the ceilings arbitrarily, unilaterally, and as a bargaining base for budget negotiations. Spending agencies thus feel that they have not been consulted and that no policy directions other than indications of amounts have been given and, consequently, they
have resorted not to priority planning but to bargaining strategies. To an extent, this result was due also to the fact that the spending agencies were more familiar with bargaining practices and sometimes lacked facilities for undertaking priority planning; they therefore found a continuation of the previous practices more convenient. Technically, the ceilings might be set without proper adjustments for the expected rate of inflation or for the maintenance outlays required for completed projects, making the spending agencies more apprehensive. Experience suggests that while devolutionary approaches are purposeful and positive, their success is dependent on the care taken in the formulation of ceilings and the attention devoted to building up a dialogue with spending agencies.

REVIEW AND EVALUATION

The discussion in this chapter has thus far been primarily concerned with the mechanics of formulation of estimates and the factors influencing the estimates. The different elements that are brought together in the budgetary process are, in turn, influenced by the structural aspects of the process and therefore merit consideration. It is suggested, although infrequently, that one reason for expenditure growth is the budgetary process itself. While it is likely that the budgetary process alone does not foster profligacy or encourage spending increases unless these are warranted by the economic climate, some aspects of the process may unwittingly contribute to increased

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14 It was a common experience in several OPEC countries for spending agencies to feel that they were not given their due share of oil surpluses, while in fact the finance ministries were trying to restrain inflation by containing expenditures.

15 Douglas Hartle contends that a significant factor in the growth of government expenditure is the budgetary process itself, although this is not the only factor. In support of this claim, he refers to the conventional belief that politicians resort to the easier option of increasing expenditures rather than raising revenues and that governments believe in increasing expenditures. At the process level, he argues that insufficient attention is given to several important problems that underlie expenditure growth and that these can be fully solved only when there is political will and recognition about the role of expenditures, not in collecting votes but in stabilizing the economy. Hartle tends to overemphasize the political aspects. While their importance is not a matter of debate, the concern here is more with the systemic factors at work within a political system that may be assumed to have specified its economic and social preferences. The role of a system is to lend clarity and facilitate the appraisal of political goals. See Douglas G. Hartle (1978), p. 6.

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expenditures or to outcomes substantially different from budget estimates. The outcome is the result of the influence of several complex phenomena, of which only a few can be anticipated and measured with precision. However, it can be stated that the degrees of variation are dependent on the recognition of constraints in the budgetary process, the instruments chosen, the time span of the budget, and the treatment of uncertainty.

The budgetary process and related decision making would be considerably facilitated by the recognition given to economic and political constraints. It should be noted, however, that a classification of constraints into neat categories is difficult. In practice, the constraints may not be distinct and may be imposed partly or wholly in the realization of economic objectives. Most economic solutions may become political problems, and most political solutions may become economic problems. In the area of public policymaking, good economics may be bad politics and vice versa. Notwithstanding the ambiguity involved, the constraints at work in the budgetary process are summarized in Table 5.

**ECONOMIC AND BUDGETARY CONSTRAINTS**

The factors shown in Table 5 are common to most government organizations. Their applicability for a national government differs according to the responsibilities of government in national economic management. For state and local governments, the amount of resources transferred to them from the central government is a significant constraint, while for the central government, the transfer of resources may be a constraint only in the implementation of selected aspects of the budget. The economic policy constraints shown in Table 5 are, in theory, expected to be taken care of in the development plans and medium-term expenditure forecasts. The success of plans and forecasts depends to a large extent on the degree of realism shown in the treatment of the constraints and on the responsiveness shown by the budgetary process to changing economic situations. It is necessary to note that mere recognition might not be adequate and might be a hazy step in the long budgetary process. To be fully operational, constraints must be recognized formally and explicitly. Otherwise, policies tend

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Table 5. Economic, Institutional, and Budgetary Constraints

1. Economic Policies
   a. Income, employment, and inflation goals
   b. Exchange rate policies
   c. Monetary policies
   d. Fiscal policy
      1. Resource mobilization
      2. Rate of expenditure growth
      3. Investment expenditures
      4. Subsidies
      5. Budget deficit

2. Institutional
   a. Consultation and coordination among levels of government
   b. Coordination within government
   c. Organizational rigidities
   d. Noneconomic considerations urged by political elements
   e. Administrative capability

3. Budgeting
   a. Approaches to revenue and expenditure estimation
   b. Flexibility in fiscal action
      1. Levels of expenditure already committed
      2. Facility in the levy of new or revision of existing taxes and rates
   c. Constraints of the budgetary process
      1. Time
      2. Information: approaches of financial control; inadequate funding
   d. Financial management
      1. Poor timing of release of funds
      2. Cost overruns
      3. Lack of flexibility in the utilization of funds
   e. Personnel constraints

To miss goals (which in most events may not be specified) and the participants tend to engage in transactions that, while leading to a budget, release forces that will reduce the relevance of the budget.

The budgetary process should also explicitly recognize the relevance and limitation of each instrument. If it is assumed, for example, that governments are clear about their economic goals, the budgetary process should facilitate an appraisal of the different instruments for achieving those goals. The government's objective of providing housing could be achieved through direct expenditures, loans, or tax policies. Similarly, industrial pollution may be reduced through
regulations, tax relief, or direct expenditure. The practical consideration of these alternatives has not yet made much headway owing to organizational and conceptual problems. Organizationally, the budgetary process has been viewed in a narrow way, as being confined to allocations to spending agencies. Furthermore, governments are so organized that each instrument may form part of the responsibilities of agencies that rarely come together. In the process, each instrument tends to be considered as a universe in itself. Yet another factor is that major activities may remain outside the purview of the budget. Moreover, the quantification of some instruments, such as tax concessions and regulations, is not easy and much is dependent on the actual response of each taxpayer. Similar difficulties have afflicted the choice between loans and direct expenditures within government and between government and commercial banking system. 17 If the fiscal policies and particularly their industrial components are to be meaningful and to present a unified picture, it will be necessary to envisage a broad budgetary process in which all the different instruments can be considered. Part of the problem could be met at the initial policy planning stage by considering the alternatives, and the budgetary process could then, as in previous years, be devoted only to the determination of allocations. These improvements are still awaited. A first requisite in this direction is clearly one of compiling an inventory of the major policy instruments now in use and of potential instruments to serve as a basis for policy formulation. It is probable that, in the absence of such efforts, concerned government departments will continue to envisage policy measures on traditional lines and will contribute to the perpetuation of the present processes.

The consideration of the budget is also influenced by the span of the budget and the duration of the budget-making process itself. While the latter aspect is considered in the following pages, it appears that the annuality of the budget may generate policies oriented to a very short term and create a tendency to postpone to a future period significant expenditure or revenue increases. Such an approach will

17 The consideration of a loan appears to be determined by the accounting technicality that it forms part of the borrowed funds of government and that its repayment would impose a certain financial discipline on the recipient. Whether loans and direct expenditures have different allocative effects is an aspect that has not received much attention, except to provide the general dictum that both must endeavor to produce benefits equivalent to their opportunity costs.
contribute (as it has already contributed) to the adoption of an "ostrich" attitude, which still cannot avoid the economic realities of life. As this attitude affects the whole tenor of fiscal policies, it is appropriate to envisage the budgetary process in a long-term context within which annual budgets can be formulated.

The effectiveness of the budgetary process is influenced by the treatment accorded to uncertainty. All policies in the public realm must be formulated against considerable odds, such as the direction of the economy, price movements and expectations, and several other variables. The revenue constraints arise partly from uncertainties which influence expenditures in an asymmetrical way. If guidelines are not available in regard to revenue constraints, the approaches of spending departments will differ from the normally expected rational pattern. As noted earlier, underestimation of revenues serves as a safety valve at the political and executive levels. Overestimation of revenues, however, can induce spending departments to make more liberal expenditure estimates and can severely strain fiscal and monetary policies at a later stage. In the long run, it may be a blessing to underestimate rather than to overestimate revenues. More important, the budgetary process should provide explicit avenues for promoting strategic planning at various levels of resource availability in order to minimize uncertainty. Along with this, control techniques will also need to emphasize a greater degree of review and evaluation of public expenditures so as to minimize evasive approaches adopted by spending agencies. Uncertainty is inevitable in a budgetary context, but the process should provide ample opportunities for its recognition and minimization. Such opportunities depend on the financial management capabilities within departments and on the initiative shown by central agencies.

Budgetary review may be distinguished from evaluation. Review is a more specific task and, in the immediate context of the budgetary process, implies a program analysis consisting of the internal consistency of each element of expenditure and its relevance to the overall framework of action contemplated in any year. Evaluation is a larger concept. Although it is traditionally used to convey a postevent appraisal, in a prospective way it implies the formulation of strategies for the realization of goals at no extra cost. Specifically, it has four basic elements: operationally defined goals; a set of indicators—output, cost, productivity, or accomplishments that indicate the
extent to which a program objective is being met; the specification of
the range of instruments for achieving program objectives; and an
analysis of the relationships between policy instruments and indicators. Evaluation presupposes strategic planning as illustrated in
Chart 1. In the ultimate analysis, both have the same purpose—
namely, given a certain amount of resources, what can be achieved?
Alternatively, given a specific goal, what are the resource require­
ments? Both of these questions raise the issue of cost and value of
services and of the values attached to them in government. If financial
planning is done on a need basis, budgeting will be an exercise of
computing the values of needs and of providing necessary amounts.
However, where planning is resource based and resource ceilings are
indicated to departments, budgeting will be an exercise in providing
relevant services for those amounts. In the case of public authorities, a
combination of these approaches is followed.

The budget process is intended to reduce conflict and to permit
decisions that are acceptable to the participants. As noted earlier, the
participants have different interests—the spending agencies seeking
greater allocations and the central agencies endeavoring to restrict the
allocations to manageable levels. To that extent, budget review
involves, on the part of the central agencies, reduction of the demands
generated by spending departments. The ability with which such
demands are resisted depends on three assumptions. First, it is
assumed that broad decisions of financial policy are settled either by
the Cabinet or similar bodies. But, within the limits laid down, there
is still much to be decided. The determination of such issues forms
part of the budgetary process. By the same token, it is implied that
issues avoided or deferred by the policymaking body cannot be solved
in the give and take of the budgetary process. Second, the success of
the central agency depends on its location and the support it receives
from the policymakers. Any battles that it proposes to wage must be
carefully planned, for the loss of a few battles could lead to losing the
war. The analogy might imply the need for the adoption of aggressive
policies by the budget agency. On the contrary, it is to be emphasized
that the policies themselves should be realistic in order to induce
conformity rather than to encourage battle lines. A central location and
strong support obviously cannot compensate for the apparent inade­
quacies of policies. Third, much depends on the techniques used for
the review of budget estimates. There are, however, many techniques,
some of which are limited in their application to specific types of expenditures.

**REVIEW TECHNIQUES**

A technique that is in extensive use in developing countries is variation analysis. This approach implies that the agencies will first identify the program or its cost elements, representing increases or reductions over the previous year's budget. Following this identification, the annual review by the budget agency focuses mainly on the variations, with greater emphasis on increases in outlays. This approach is based on the belief that the items continuing in the government budget merit further extension and will be reviewed only when special situations demand it. The budgets of previous years will then represent a threshold point beyond which no research is needed. Budget review will in part become a folk rite with inbred complacency in regard to the policies that are already there. The technique has several weaknesses, but the most pernicious is that such approaches are accepted as conventional wisdom, supported not by their content or relevance but by history, and that they become impediments to the revitalization of government financial management.

An equally conventional technique that continues to be practiced is the item-by-item review, which involves a review of the annual budget requests in terms of specific objects such as wages and related payments and materials. A general problem associated with this otherwise powerful approach is that it tends to concentrate on the minutiae and thus, in the process, neglects the more important policy issues. The technique has a wide following and has withstood the test of time—two factors that add to the instant appeal of the technique. As discussed later in Chapter 11, the aim of budgetary reform has been to move away from this approach.

With the advent of planned economic development, and with efforts at the introduction of performance budgeting, some change took place in the application of techniques of budgetary review. Planning implied the adoption of a language of priorities by the spending agencies. Specifically, for projects and programs, the spending agencies indicate their priorities, which are then analyzed by the budget agency. Performance budgeting implies an evaluation of the requests in terms of workload, costs of activities, standards of performance, and related
criteria. Variations of this technique have since dominated budget reviews and have led to partial adoption of the evaluation approach described earlier.

More recently, improved techniques have been adopted in specific recognition of the growth in expenditures and their complexity, the change in economic environment, and shortcomings in the prevailing budget systems. These techniques may be grouped into three categories: (1) improved budgetary systems, including the introduction of zero-base budgeting, multiyear budgeting, budgeting in volume terms, and “sunset” legislation; (2) budget techniques for demand management, consisting of government approaches to bring about short-term changes in approved expenditures to meet demand management requirements; and (3) supplemental management systems and evaluation techniques, comprising improved data systems to facilitate analysis of selected areas. As most of these are discussed in greater detail in Chapter 11, it is sufficient to recognize here that budgetary techniques have been responsive to change. A caveat should be noted. These techniques reflect only the range available to government and are not necessarily typical of all situations or all countries. In practice, no single technique is used exclusively, but a combination of approaches is likely to be adopted.

WORKING OF TECHNIQUES

If the techniques are used as expected, how is it that budgetary outcomes differ from the estimates? The answer is to be found partly in the working of the institutions and partly in the approaches that govern the application of the techniques. Granted that revenues are underestimated purposely, what can be said about the underestimation of current expenditures and the overestimation of investment or development expenditures? Underestimation of current expenditures is ascribed to the general philosophy that spending less on the current account would provide for investment and, regardless of the merits of the view, spending agencies often pay lip service by understating the realities. In some respects, particularly in regard to demand-related expenditures, available techniques of forecasting do not permit estimates with minimal errors. Departments also have a persistent upward bias in their estimates, so that the estimates tend to become self-fulfilling prophecies. Institutionally, apathy and lack of facilities
within agencies have caused less attention to be paid to major issues and, in the process, the burden has shifted to the techniques of budget review. This shift contributed partly to the adoption of arbitrary approaches for the review of estimates. Hartle contends that judgments in budget formulation are basically arbitrary and that the budget-making process legitimizes these decisions.\textsuperscript{18} In a way, Hartle's comment is an extreme one and implies a paradox. It must be recognized that arbitrary approaches have serious limitations and can be applicable only for brief periods.

It is hardly necessary to emphasize that the adoption of mechanistic approaches without a philosophy toward budget making would alone not be fruitful. The philosophical aspects of budgetary approaches have been analyzed by several political scientists, notably Caiden and Wildavsky, Crecine, and Cowart and Brofass.\textsuperscript{19} These studies primarily hypothesize that the approaches to budget making are linear and predictable. Although several propositions have been subjected to limited empirical tests, some of the more important ones may be noted. It is argued that the approaches would be one of the following five: (1) requests at last year's levels would generally be approved by the budget agency; (2) any increase in the allocations over the previous year's levels is dependent on the influence or power of the spending agencies and the magnitude of revenue likely to be available during the next year; (3) the budget review tends to be superficial in the context of greater availability of resources; (4) in the event of a likely budget deficit, an attempt will be made to balance the budget through reduced allocations; and (5) when a surplus is likely to be available, more fringe benefits are likely to be approved for government personnel. These approaches, while based on practical experience, also reflect oversimplification of realities. To be sure, the applicability of these propositions will differ in terms of the levels of government and will vary with the economic environment. The approaches imply that budgeting is purely a bargaining process, that merits of programs do not determine their eligibility, that there is no government policy, and that governments do not distinguish between economic and financial constraints and that, in short, the budgetary process has ceased to have

\textsuperscript{19}See Caiden and Wildavsky (1974); Wildavsky (1975); Crecine (1969); and Cowart and Brofass (1979).
a policy function. In conveying these implications, analysts have tended to generalize on limited bases, and they may have confused symbols with substance. At the same time, it cannot be said that the propositions are entirely untenable, for they are partially true. The danger consists in believing in their universal applicability and in assuming that the budget is the result of a unilateral approach. The analysis in the preceding sections illustrates the complexity of budget making, and it also demonstrates the role of numerous forces at work. The success of the budget review and the associated budget-making process, to summarize then, is dependent on (1) explicit recognition of the constraints; (2) recognition of the economic forces at work and the role of the budget in changing them, including the time lags with which budgetary policies come into effect; and (3) recognition that the budgetary process should assign appropriate weights to planning and management.

**Economic Analysis of the Budget**

The central role of the budget in economic management has been emphasized earlier. To recapitulate the discussion, although political views and views on the role of the state differ and important differences are to be found between interventionist and noninterventionist policies of government, a common factor is the recognition of the budget as a significant instrument of economic management. Over the years, there was greater recognition of the impact of the budget on the economy and the economy's impact on the budget. In these matters, annual decisions both within and outside the government relate to the amount of stimulus or restraint to be exercised on the economy. Indicators of employment, prices, economic growth, and balance of payments have become important in determining appropriate annual expenditures, but they have not been given the emphasis due in the traditional literature on government budgeting. To a certain degree, this lack of emphasis reflected the apathy found in bureaucracies, as the budgeteer considered the economic aspects as alien to his day-to-day activities. Such an isolationist approach led to serious differences between budgetary policies and the formulation of budgets. On occasion, it looked as if there was no significant connection between the budget speech and the accompanying documents and as if they were brought
together hurriedly. This stage has largely been overcome, and experiences in industrial and developing countries reveal that economic analysis has become an integral part of budgeting. While organizational differences between the role of the economist and the budgeteer still persist, the new realities are that each acts as a parameter and as a disciplining force to the other. The budgetary process has also been facilitated by the growth of macroeconomic theory to allow causal relationships between major economic aggregates. Research techniques that permit a greater quantification of variables in the formulation of fiscal policies and, in particular, in the analysis of alternative policies have also become available. The major issues are whether the effects of the budget are in the right direction and are of sufficient magnitude. In providing answers to these questions, consideration should be given to (1) the theory selected to explain the macroeconomy, (2) the nature of the economy (industrial or developing), and (3) the type of measures chosen to assess the budget impetus.

THEORETICAL APPROACHES

The growth of Keynesian economics has, as noted in Chapter 1, had a profound effect on the development of fiscal policy in industrial countries. The major goal after World War II was to achieve full employment in these economies, and it was believed that this could be carried out through the management of demand. It later became clear, however, that full employment could not be achieved in this manner without accompanying price instability and balance of payments problems. Later, by the 1960s, the belief was that demand management coupled with incomes policies would reduce pressures on prices. This approach, which stresses aggregate demand as an essential aspect of stabilization policy, is based on the premise that a stimulus to aggregate demand leads to an increase in demand and thus contributes to the growth of GNP. The stimulus, in turn, can be provided through increased government expenditures. Expenditures of government create incomes and stimulate demand, and revenues reduce the purchasing power or the demand of the community and—in a context where expenditures grow at a higher rate than revenues—they have the
capacity to add to real resources. Conversely, an increase in government revenues reduces the purchasing power of the community and releases real resources for the public sector. In the process, demand pressures are also reduced. This framework of aggregate demand management continues to play a major role in fiscal policy, although its efficacy is debatable. Another approach labeled as monetarism suggests that real wages and real interests in the economy are determined by the forces of supply and demand. According to monetarists, a government budget deficit (as the difference between total expenditure and revenue) that is financed by borrowing from the central bank induces substantial credit expansion and contributes to increased prices. Further, advocates of monetarism suggest that a deficit that is financed by government borrowing "crowds out" private expenditure and contributes to higher interest rates and that the employment level, which is the basic concern of government, is basically unaffected. After crowding out private sector operations, government activities supplant them but may not add any new employment capacity in the economy. At the same time, however, price increases occur. Monetarism implies that the economy is basically stable and that fiscal intervention through higher deficits has durable effects on liquidity. However, if the assumption of basic stability of the economy is relaxed, then a greater role may be indicated for the budget. The demand management and monetarist approaches emphasize, respectively, the fiscal and liquidity impact of the budget on the economy. In practice, budgetary impact on the economy includes both fiscal and liquidity effects. Fiscal effects are transmitted through purchases of goods and services that represent a net claim on real resources or GNP, and taxes and transfer payments to households and the corporate sector in the budget affect the buying power of the community and, thus, spending for consumption and investment. Liquidity effects flow from government operations affecting the size and composition of government debt.

These broad approaches reflect the framework within which the impact of the budget must be analyzed. The degrees of emphasis and areas of adjustment differ, depending on the situation. One major area of particular concern to open economies is the impact of government operations on balance of payments. In particular, in the context of floating exchange rate systems, the movement of a country's money supply relative to other countries has a significant effect on its
exchange rate. It is implied that if there is a contraction in public spending and in the domestic money supply, an improvement in the domestic inflation rate is achieved only if the exchange rate is allowed to appreciate. Conversely, the exchange rate depreciates when the public expenditure and money supply are expansionary. The exchange rate is an indicator of the stance of fiscal and monetary policies in terms of a country's dealings with the rest of the world.

The different theories must recognize the structural differences between industrial and developing countries. It can be argued that the basic tools of analysis are the same regardless of the income or economic levels of countries. However, there are well-recognized differences that imply varying degrees of applicability for fiscal and monetary tools. In industrial countries, fiscal policy or demand management within the Keynesian framework consists of reducing unemployment and stimulating demand through deficit spending. In budgetary terms, goals of the developing world are focused on growth and capital formation. Indeed, the key problem for budgetary analysis is one of channeling the available resources for capital formation.

**Nature of Effects**

It has been noted that government revenues tend to have an income-reducing impact on the community, while government spending has an income-stimulating effect. However, while the underlying philosophy is accurate, the same may not be said about every source of revenue or type of expenditure and borrowing. Much depends on institutional arrangements and, in respect of debt, on monetary policy. It is therefore appropriate to discuss the broad considerations governing budget categories. In doing so, however, it is recognized that there are certain common budgetary features. First, economic analysis implies an agreed definition of the government sector. The budget includes...
not only the administrative budget, which for various reasons may be limited, but the operations of the government sector as a whole. Although, as discussed earlier in the chapter, the definition of general government and public sector has ambiguities, the national accounts systems offer a useful starting point. Second, economic significance is to be found in the impact of the budget on the economy during the period for which the budget is computed, implying the need for ascertaining the cash flows inherent in the proposed budget. Items that involve incurring obligations but no cash outlays need to be excluded.\(^{21}\) Third, attention needs to be paid to the timing of changes in taxes or expenditures, as there may be lags before their effects are realized. Fourth, the concern here is with the first-round effects of the budget and not with the subsequent chain of events. Although the subsequent impact is also important, its measurement is problematic as it hinges on the lags and empirical relationships between income, consumption, and saving.

The impact of each budget category is unique. Without making an extensive and detailed analysis of each component, it is appropriate to consider certain broad behavioral properties, which are summarized in Table 6. Taxation, by assumption, results in a reduction of consumption. But certain taxes, such as capital levies, estate taxes, and revenues derived from existing assets (as distinct from newly created assets) may not be paid from current income and therefore may not curtail consumption. In reconstructing the budget for purposes of economic analysis, it would be ideal if transactions that do not impinge on current income could be treated separately for measuring the true inflationary impact of the budget.\(^{22}\) Similarly, the impact of business income taxes is difficult to measure, as part of these taxes would accrue in the form of individual income taxes and therefore would be deflationary. But, in part, business income taxes also represent potential investment. Indirect taxes, including excises and sales taxes, would need specific assumptions in regard to their incidence and shifting. If they are paid by the producer, such payment would represent a reduction in income and would be treated like income

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\(^{21}\) The choice of the base of accounting that would best reflect the budget impact has been a matter of some debate and is considered in Chapter 13.

\(^{22}\) One of the earliest clinical approaches for the measurement of the impact of the budget categories was by William H. White (1951), pp. 355-78.
taxes. When the tax incidence is on the consumers, however, payment of excises and sales taxes does not affect disposable income but may affect the propensity to save or consume as it is influenced by the real income. Indirect taxes, including duties, add to the cost of materials and raise prices. The effects of taxes on consumption must therefore be carefully balanced by their contribution to higher prices and inflation.

The impact of grants, which is sizable in the budgets of developing countries, needs to be identified separately. Grants represent only a part of the overall package of foreign receipts, which include foreign borrowing. In Table 6, a distinction is made between grants, which are shown along with tax and nontax revenues, and borrowing from abroad, which is shown in the financing part. Foreign receipts when spent abroad are neutral in their impact on GNP and the balance of payments, as they constitute no demand on the real resources of the economy. When foreign receipts are spent within the domestic economy, they constitute a demand on the resources and as such have an expansionary impact on GNP and a favorable impact on balance of payments.

Expenditures encompass a wider variety of components than do revenues, but the major consideration in analyzing the budget impact is the extent to which spending by government creates a demand on the supply of resources becoming available from domestic output and imports. Various categories of expenditures have different implications. In measuring the impact of expenditures, their classification into current and capital expenditures is not relevant. (That concept may be needed for ascertaining the government's contribution to the financing of growth, which is considered later in this chapter.) The classification of expenditures depends on the purposes of the analysis. Expenditures have important effects on output, income, and balance of payments, as well as on distribution of benefits. In view of the diverging policy goals, each broad objective of economic policy may need a different classification. For example, government's requirements of goods and services may exert a strong influence on the structure and location of industry, as is true for defense purchases in industrial countries. In some cases, commodity purchases by government would be helpful in ascertaining the draft on scarce resources. In some countries, particularly in developing ones, it may be necessary to show the import or foreign exchange component of expenditures, with a view to determining and budgeting the needed foreign exchange.
Table 6. Scheme of Economic Analysis of the Budget

<table>
<thead>
<tr>
<th>Budget Categories</th>
<th>Effects on Aggregate Demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Receipts</td>
<td></td>
</tr>
<tr>
<td>Tax revenues</td>
<td>Broadly deflationary in view of the possible reductions in demand. Several qualifications operate and much is dependent on whether these payments are made from the current stream of income or from balances.</td>
</tr>
<tr>
<td>Nontax revenues</td>
<td></td>
</tr>
<tr>
<td>Grants</td>
<td>Net impact is neutral when grants are spent abroad.</td>
</tr>
<tr>
<td>2. Expenditure</td>
<td></td>
</tr>
<tr>
<td>Current expenditure on goods and services and capital formation</td>
<td>Government expenditures add to aggregate demand and involve net claims on resources. (Purchase of existing assets is excluded from capital formation.)</td>
</tr>
<tr>
<td>Transfer payments</td>
<td>Generally reflect additions to the money income of households. Subsidies add to the real income of households and their overall impact is dependent on the nature of subsidies and their incidence on producers and consumers.</td>
</tr>
<tr>
<td>Net lending</td>
<td>Generally expansionary as they increase aggregate demand; but the impact of fiscal offsets such as increase in revenues or reduction in expenditure has to be taken into account.</td>
</tr>
<tr>
<td>3. Deficit (1–2)</td>
<td></td>
</tr>
<tr>
<td>4. Financed by</td>
<td></td>
</tr>
<tr>
<td>1. Foreign debt</td>
<td>Generally has an expansionary impact but a favorable and countervailing impact on balance of payments.</td>
</tr>
<tr>
<td>2. Domestic debt</td>
<td></td>
</tr>
<tr>
<td>a. Nonbank borrowing (private households)</td>
<td>Contractionary in view of the implied reduction in purchasing power and demand. No significant impact on aggregate demand is likely if contributions are from idle balances.</td>
</tr>
</tbody>
</table>

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Table 6 (concluded). Scheme of Economic Analysis of the Budget

<table>
<thead>
<tr>
<th>Budget Categories</th>
<th>Effects on Aggregate Demand</th>
</tr>
</thead>
<tbody>
<tr>
<td>b. Commercial banks</td>
<td>No expansionary effect if adjustment is made through curtailment of credit to the private sector. However, where participation by commercial banks becomes possible through additional credit accommodation by the central bank, it would have an expansionary effect on aggregate demand.</td>
</tr>
<tr>
<td>c. Central bank</td>
<td>Expansionary impact on demand through increased income and through additional liquidity.</td>
</tr>
</tbody>
</table>

resources.\(^{23}\) For convenience, however, expenditures are classified into money spent on goods and services, which constitute direct claims on resources; transfer payments, which are indirect claims on resources; services comprising outlays on wages and salaries, which on average constitute more than half of expenditures in developing countries; and gross capital formation, which includes new additions as well as increases in stocks. Excluding the taxes paid in the acquisition of goods and services, outlays on goods and services cause, almost one to one, corresponding increases in demand and inflationary pressure. Transfer payments comprise a large variety of transactions, ranging from interest payments, pensions, and subsidies to households and productive sectors to grants to individuals. When such transfers lead to additional money income, further demand pressures would be created, depending on the propensity to consume. The demand so created will not, unlike goods and services, have a direct relationship in terms of demand and will differ according to the nature of the transaction. If proper analysis is to be made, the impact of each must be identified separately.\(^ {24}\)

\(^{23}\)In Australia, government budget expenditures show the domestic purchase component and foreign expenditures.

\(^{24}\)Several countries have formulated estimated demand weights for categories of expenditure. For an illustration in the United Kingdom, see the Expenditure Committee's report, Public Expenditure and Economic Management (1972b).
Another category of importance is government lending. It is generally accepted that government is not in the business of lending money to make profits like a banking or financial institution. Lending is undertaken by government to further a policy objective that is not served by normal expenditures and is of two types—aid to other countries and lending within the economy. Lending to countries, when given in the form of tied or conditional spending in the country extending aid, should more appropriately be considered as expenditure. Loans given to infant industries, small landholders, and a variety of other recipients constitute an increase in the aggregate demand, although the impact may be less than that of direct claims but more than that of transfer payments.

Government borrowing offers a different problem because it is the area where the liquidity impact of the budget and the links with monetary policy become clear. Borrowing from individual households, which may not be a sizable amount, could imply a contractionary effect in some situations. Public participation in the government borrowing program is not compulsory as is taxation. Taxes reduce consumption by impinging directly on the stream of income. Willing purchase of government bonds by the public implies that the monies come from previous savings and not from current income. However, a reduction in the purchasing power and demand could be implied if bond purchases come from current income and are induced by high interest rates and related tax concessions offered by government. Once the matter of interest rates is introduced, several possible results need to be considered that involve a more extended consideration of monetary policy.

Government bonds are also bought by commercial banks. Banks may extend credit to government by reducing the credit allotted to the private sector. When this adjustment of credit is within a fixed amount, there will be no impact on aggregate demand. However, when credit is extended by banks from excess reserves or accommodation by the central bank, additional liquidity will be injected into the economy, with a resulting expansionary impact on aggregate demand.

25 In the United States, transactions shown as loans in the budget are treated in the national accounts as expenditures in the form of grants, in view of their tied nature and long amortization and grace periods.
The same phenomenon arises when the central bank provides credit for financing the budget; the greater the reliance on the bank the greater the impact on aggregate demand is likely to be.

The identities in Table 6 show the broad trends of the impact of the budget. A balance between revenue and expenditure does not necessarily mean that the stimulating effects of expenditure and the restricting influences of taxes are neutralized. Fiscal policy considerations do not end with the accounting balances in one year but are concerned with the change from the previous year and the directions of that change. The budget balance is affected not only by what the government does but also by changes in the economy. Even if the budget is not altered, it undergoes changes from year to year. Tax revenues, reflecting the progressivity of the system, may be more than expenditures when economic activity is high, or expenditures may be higher than revenues because of automatic stabilizers when economic activity is low.

CONCEPTS OF DEFICIT OR SURPLUS

Central to the whole economic analysis is the concept of deficit in presenting budgetary data. Budget deficits were considered in the past to be reprehensible and to indicate bad financial management. The cardinal rule was to balance the budget—a rule that continues to dominate budget making in several countries. In Japan, Indonesia, and the Philippines, for example, it is a constitutional requirement that the budget should be balanced. The balance specified is an accounting balance that requires receipts to be equal to outlays. In practice, such insistence necessitates procedures that include borrowing in the overall receipts. An accounting balance alone does not indicate the underlying economic currents, for, by definition, the totals on both sides of the balance sheet are equal.

In reorganizing the entries on the receipt and expenditure sides of the budget, the basic aim is to facilitate the formulation of economic policy. For this purpose, over the years several measures have been advanced, which may be categorized as (a) single measures, (b) the component approach, and (c) cyclical measures. A common feature for all three approaches is the reliance on and use of national accounts. The single measure’s reliance on national accounts is much less and is of recent origin, as will be illustrated below.
The single measure’s approach has grown over the years, reflecting the tasks of economic management and the changing economic philosophy. Four distinct concepts have been developed, each one reflecting the demands of economic analysis: (1) the public debt concept of deficit, (2) the net worth concept of deficit, (3) the overall deficit, and (4) the concept of domestic budget deficit.

The public debt concept of the deficit is illustrated in Table 7, where the measure of budget deficit is defined as the difference between revenue \( A \) on the one hand, and current expenditures \( C \) and net acquisition of assets \( D \), on the other. This measure \( A - C + D \) is equal to net borrowing \( B \), adjusted for any changes in cash holdings of government. However, as cash holdings are likely to be insignificant, the budget is considered to be balanced if net borrowing remains unchanged from previous years or is equal to zero. The public debt concept offers an illustration of the pre-Depression prudent fiscal policies that emphasized balanced budgets and considered debt as an extravagance on the part of the government and as having no justification except in wartime. The implementation of such a budget meant a rigorous discipline but lacked flexibility for economic stabilization purposes. The public debt concept implied that the best fiscal policy consisted of restricting spending to the amount of tax revenues. Later, however, when active fiscal policy had become an imperative, it was felt that the government could borrow as long as the consequent liabilities were matched by an increase in assets. This led to the development of the net worth concept of deficit. In terms of the illustration in Table 7, net worth is defined as the difference between current expenditures and revenues \( C - A \), which is equal to the excess of net borrowing over the net increase in assets \( B - D - E \). Implicit in the measurement of net worth is the requirement of the division of the budget into current and capital expenditures, with the latter being financed by borrowing.

A variation of this approach is the concept of current account surplus. The current surplus seeks a measure of the savings that a government manages either by mobilizing more revenues or by limiting current expenditures. The use of the concept has several implications that may be examined in terms of resource effort and
Table 7. A Typical Budget Balance

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Revenue (tax and nontax)</td>
<td>C. Current expenditures</td>
</tr>
<tr>
<td>B. Net borrowing</td>
<td>D. Acquisition of real and financial assets other than cash</td>
</tr>
<tr>
<td>A + B</td>
<td>C + D + E</td>
</tr>
<tr>
<td></td>
<td>E. Increase (+) or decrease in cash holdings</td>
</tr>
</tbody>
</table>

Budget management. The latter aspect, which is primarily concerned with structures of the budget and their implications for budget making, is considered in Chapter 10. From the point of view of resource effort, the concept is useful in ascertaining the extent of resources shifted from the community to the government. In developing countries, this measure is used for assessing the magnitude of public saving and its contribution to the overall development effort. Frequently, the measure is also used by donors of aid to ascertain the extent to which a community is sacrificing its current needs for future purposes. The concept, however, does not illustrate the impact of the budget, and its usefulness is limited to being an exercise in the mobilization of resources.

Overall Balance

The concept of the overall deficit or balance has several connotations and methods of construction.\(^27\) For the purpose of this discussion, the overall deficit is the one illustrated in Table 6, which shows revenues, expenditures, and borrowing as distinct groups, each of which could be used singly or collectively to assess the impact of the budget.\(^28\) Each

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\(^{27}\) For an illustration of the practices in the late 1960s, see United States, President's Commission on Budget Concepts (1967a). For a more recent survey, see United Kingdom, Expenditure Committee, Memoranda on the Control of Public Expenditure (1978a).

\(^{28}\) For an extended discussion of this approach, see International Monetary Fund (1974). Categories shown in Table 6 differ from those in the Manual in matters of detail. For a discussion of the relationship of this concept to national accounts, see Poul Høst-Madsen (1979).
budget category may be related to economic activity by computing it as a ratio of GNP. The overall budget balance or overall deficit, expressed as a percentage of GNP, provides a first approximation and an important single measure of the impact of government fiscal operations. To the extent that it is formulated in advance and revised concurrently during the preparation of the budget, it shows the likely demand effects, as well as the liquidity effects from financing, that are flowing from the budget. However, if the balance is formulated after the budget activity is completed, as is the case in a number of developing countries, its usefulness is only ornamental. More significantly, it implies that the budget is prepared mainly as an accounting exercise and that any economic policy is incidental rather than a guiding spirit.

A variant of the overall budget deficit concept is the domestic balance concept, which came into prominence after the oil price increases in 1973–74. In countries that had large revenues, expanded incomes from government expenditures placed strains on the domestic economy and spurred inflationary pressures. In such cases, budget surpluses, which are expected to have contractionary effects, have in effect proved to be expansionary. The overall budget deficit or surplus concept would be misleading as a policy tool in such a context. To meet the specific requirements of oil producing exporting countries, and other countries in similar circumstances, the technique of splitting the budget into domestic and foreign components has been advocated. Under this approach, the domestic balance is the component of the overall balance from which external budget transactions have been excluded. To illustrate, if country X has a surplus external balance of 500, and if its overall budget surplus is 200, it has a domestic deficit of 300. These aspects need to be analyzed further in terms of the liquidity effects of the budget but this measure indicates broadly the nature of the impact on the domestic economy. The usefulness of the technique lies in revealing the element that would otherwise remain hidden in the aggregative approaches to the overall balance.

These last two techniques have both conceptual and operational limitations. First, the operations and tasks of government are too complex to be satisfactorily captured in a single statement. While this is true, the advantage of the overall balance is that it provides the basic information in a useful format. Second, the technique of the overall balance is an unweighted exercise, implying that all budget items have
the same absolute value, and to that extent it oversimplifies a problem rather than trying to solve it. Third, as already noted, the overall concept does not recognize the domestic and foreign components separately. But if it is supplemented by the domestic budget balance concept, the policy purposes are better served. The operational problem lies in evolving appropriate criteria for the separation of the domestic and external sectors and in maintaining budgetary data in terms of domestic and foreign expenditures. For example, salaries paid in foreign embassies may be repatriated or goods bought from local stores may actually have been imported. While these concepts do not give the final answers to the budget question, they provide a method of calculation that is perhaps a significant step beyond the intuitive approaches prevalent in the past. The major problem continues to be one of integrating these analytical processes with the budgetary process.

OTHER CONCEPTS

To compensate for some of the shortcomings of the aggregative approach of the overall balance concept, a component or weighted balance approach to the budget has been formulated.\(^\text{29}\) This approach involves the assignment of weights to different categories of revenue and expenditure. The balance derived from the sum of the products reached by multiplying each budget category by its coefficients is considered to be indicative of the budget impact. The choice of weights is based on extensive empirical work, as otherwise there is the danger that they would reflect prima facie judgments on the nature of financial transactions. The use of the concept has not been very extensive, partly because of this danger and also because the coefficients vary over time and among categories. It is difficult to evolve a schedule without specific time limits, given that the economy itself is in a state of flux. The technique, where used, has been helpful in ascertaining the impact on the balance of payments. In countries where increased incomes generally translate into increased demand for imports, this approach is a useful guide.

The overall balance approach and the other approaches described here mainly seek a relationship with the GNP. Three major concepts,


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with varying degrees of success and applicability that have developed
during the last four decades seek to relate the budget deficit to the
stage of the business cycle and they involve the separation of the
budget effects on the economy from those of the economy on the
budget. The three concepts developed in the United States, the Federal
Republic of Germany, and the Netherlands, respectively, are the full
employment surplus or balance concept, the cyclically neutral balance
concept, and the structural budget margin concept. These concepts
have complex features and have been the subject of considerable
academic study in recent years. The following discussion aims at
presenting the main features of the concepts, their limitations, and
current use.

FULL EMPLOYMENT BUDGET

The full employment budget concept was evolved in the late 1950s
and found acceptance in 1972 when the President of the United States
used it in his annual budget message. In essence, it represented a
budget in which the expenditures would not exceed the revenues
generated by the economy at a full employment level, which was
defined for the purpose as equivalent to 4 percent unemployment of
the work force. The message noted that the "full employment budget
is in the nature of a self-fulfilling prophecy. By operating as if we were
at full employment, we will help to bring about that full employ­
ment." The concept is a hypothetical construction designed to show
the estimates of revenue at an assumed full employment level of output
for the existing or assumed structure of taxation and the existing or
projected levels of government expenditure. Inasmuch as it is related
to an economy moving on the path of full employment, it differs from
the actual budget and is also independent of the short-term fluctua­
tions of the economy. The concept is quantified by projecting revenues
as a part of GNP on the basis of the existing or desired levels of
taxation, and expenditures are adjusted for unemployment benefits

30 For a selective discussion of these concepts, see Sheetal K. Chand (1977),
Thomas F. Deenbarg (1975), pp. 825–57; Daryll A. Dixon (1973), pp. 203–26, and
(1972), pp. 615–46; and Theo A. Stevers (1968), pp. 44–73.
31 United States, The Budget of the United States Government, Fiscal Year 1972
that would be paid at the level of 4 percent unemployment. The other
government expenditures are assumed to be unaffected by deviation
from full employment levels. The size of the full employment budget
surplus or deficit is calculated by ignoring the part of the actual budget
margin that is due to cyclical factors or to the divergence of the
economy from full employment. The full employment budget surplus
or deficit varies therefore, not with the level of economic activity but
with reference to the level of expenditure and pattern of unemploy­
ment benefits, on the one hand, and the rate of taxation, on the other.
The concept has been utilized primarily as a presentational tool to
demonstrate the need for cyclical deficits, use of countercyclical policy,
and acceptance of actual budget deficits. This had some initial appeal
in justifying the actual deficits in terms of the surplus at full
employment level, but tended to be viewed later in some quarters as a
self-fulfilling prophecy for greater and continuing deficits.

The full employment concept itself was subjected to debate on a
broad level in terms of being a diversion of attention from the actual
budget to more detailed criticisms of its clinical aspects. The principal
use of the concept to demonstrate the need for deficit in a period of
recession was generally accepted, but what was questioned was the
methodology used. If the concept were to serve as a norm, what would
be the appropriate level of the surplus in the long run when the cyclical
factors are eliminated? As a cyclical measure, it presented several
difficulties. For one thing, it consists of an unweighted exercise; for
another, it extrapolates actual effective tax schedules without proper
weight to changes in the shares of taxes consequent to budget changes.
Also, the rate of price increase to be used for computing money
incomes and tax collections at full employment levels does not appear
to have been given due weight. For these reasons, the concept did not
achieve full operational effect and remained useful only for educational
purposes.

Cyclically Neutral Budget

A different measure was developed in the Federal Republic of
Germany, in which the budget norm is divided into "neutral" and
"cyclical" elements. Under this norm, the actual government expendi­
tures are considered neutral when they remain a fixed proportion of
potential output or GNP and when the ratio of tax revenues to actual
GNP is the same as in a base year. For this purpose, 1966 was chosen as the base year in which the neutral expenditure ratio was 28.5 percent and tax revenues were 22.9 percent. The neutral deficit in subsequent years was one that resulted when expenditures grew at the same rate as potential output and revenues at the same rate as actual output. The objective of the exercise is to ensure that government expenditures do not grow at a higher rate than the potential output and thus claim more real resources for the economy. In the short run, the concept implies that, when the actual GNP falls short of potential output, neutral revenue is reduced in proportion to the GNP shortfall while cyclically neutral expenditure remains unchanged. The concept is applied by relating expenditures to potential output and revenues to actual GNP values at the same rates as are found in the base year. The actual budget balance in each year is tested against the computed neutral balance and, if the actual deficit is more than the neutral year deficit, it is considered to be expansionary. If the actual deficit is higher in a boom year, it would exacerbate inflationary pressures, while in a year characterized by recession, it would be countercyclical.

The German concept was evolved at a stage when the economy was growing and was intended to minimize the revenue-induced expenditures that would otherwise take place. It was also based on the feeling that the base year represented a norm. The concept itself, however, had some limitations in that, like the full employment surplus, it did not distinguish among the categories of expenditure, nor did it provide for the separation of the impact of the economy on the budget. Also, if it had been used, it would have meant that the base-year approach would have become a new orthodoxy, with all the rigidity implied. The German authorities have not used the concept in their official publications, as it is considered that the concept needs further refinement.

**Structural Budget Margin**

A variation of the neutral budget concept is to be found in the structural margin concept developed by the Netherlands authorities about the same period. The concept is related to the automatic revenue increase resulting from the capacity real growth in the economy that is considered as the budget margin that could be utilized either for tax cuts or increasing expenditures. The concept had its origins in an
attempt to restrict the tax burden. The use of the concept consists of testing the annual revenue and expenditure decisions against a structural standard that is derived from the trend of growth of national output and the tax system. For purposes of calculating the "margin," it is expected that budget revenues and expenditures would increase at the same rate as the structural increase in national income. If tax rates are not lowered and, given the progressivity of the system, tax revenues will increase faster than national income. The sum of the margin is then calculated as the sum of the proportional increase of government expenditures and the trend-based growth of tax and nontax revenue. This algebraic sum is then used either for reducing taxes or increasing expenditures, but both types of adjustment must remain within the sum. For operational purposes, the Netherlands authorities established a norm for the structural budget balance, starting from a base year in the mid-1960s in which employment and the balance of payments were considered to be in equilibrium. For assessing the medium-term budget policy, this norm of the budget balance is used as in the case of the cyclically neutral budget concept. To mitigate the overall impact of the progressivity of the tax system and inflation, a partial system of indexation of personal income tax was introduced in 1971. On the expenditure side, the budget is divided into relevant and nonrelevant expenditures. The latter include debt repayments, contributions to international financial institutions and related expenditures and are excluded from budget analysis. The margin arrived at on these bases is then used for "impulse analysis," which is designed to determine the net stimulative effect of the actual budget on the level of aggregate demand and thus is more concerned with cyclical fluctuations in the economy.

The implementation of the technique, which was in use for some years, ran into difficulties in the mid-1970s, both in technical and political terms. Technically, it was recognized that a budget norm evolved for the purpose of maintaining a budget balance and the choice of a base year in the 1960s was no longer appropriate in a changed context where the aims of the budget policy are to prevent a decline in the real medium-term growth and increase in unemployment. The deficit or balance norms are now derived from a medium-term macroforecasting model. The Netherland authorities also changed the acceptable budget margin deficit from an absolute amount to a constant percentage of income. In a context in which private
investment was growing slowly, it was considered acceptable for the actual financial deficit to exceed the fixed percentage of national income. This, however, led to a rapidly rising deficit and very soon severe problems were encountered in financing it. In turn, this led to the introduction of a procedure known as the "emergency brake," which consisted of setting an upper limit for the deficit as a percentage of national income. Operationally, the structural budget margin emphasized the margin or deficit rather than the desirable volume of spending, which, in principle, could be widened or narrowed as desired by means of fiscal measures. Also, as higher-than-expected inflation led to an increase not only in public expenditure but also in revenue, the concept did not exercise any downward pressure on the budget. In political terms, it appears that the concept was used by the coalition of parties in power, either to increase revenue or to reduce expenditure.\textsuperscript{32} For these reasons, the use of the technique was temporarily abandoned in preference to a macroforecasting model. (The features of these measures are summarized in Table 8.)

Some of the shortcomings of the techniques have already been discussed. If the overall budget deficit is a simple and straightforward initial assessment, the component approach, while offering a more detailed look, also implies a static and linear picture of the economy. The cyclical concepts offer useful hints of the direction of the economy but are less than precise in measurement and are in need of refinement.\textsuperscript{33} These aspects do not, surprisingly, militate against economic analysis but they do indicate the continuing need for more work in this area. Their application to developing countries has not been possible because of the structural differences noted earlier. Further, these concepts emphasize the estimation of potential output, the computation of which is rendered doubly difficult in view of the uncertainty of the crop outcome in these economies. In some cases, application has been achieved by substituting trend incomes as related to potential output. In a few cases, calculations are made as integral parts of an econometric model, but their reliability is no more than that of the model itself. There is still much progress to be made.


\textsuperscript{33}Also they do not offer any useful guidance on the monetary consequences of the financing of the budget, which need to be studied separately.
<table>
<thead>
<tr>
<th>Description of Concept</th>
<th>Revenues</th>
<th>Expenditures</th>
<th>Budget Balance</th>
<th>Status of Concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall budget deficit</td>
<td>Generally relates revenues as a ratio of GNP</td>
<td>Relates expenditures as a ratio of GNP</td>
<td>Emphasizes the level of the overall deficit (or total borrowing) as a ratio of GNP. If the movement is positive from the previous year, it is considered to be expansionary</td>
<td>Normally utilized as a first approximation of the effect of fiscal activities on income, but measurement is less precise. A useful benchmark in budgeting and facilitates a quick identification of the changes in total borrowing and their implications to cash management. A general rule of thumb for those engaged in fiscal policy formulation</td>
</tr>
<tr>
<td>Component approach</td>
<td>Weighted budget balance approach</td>
<td>Weighted budget balance approach</td>
<td>Sum of the products derived by multiplying each budget category by its weight is considered as the weighted budget balance. Its impact on GNP is considered as a reliable indicator rather than overall budget deficit</td>
<td>This approach is used in formulating econometric models to ascertain the directions of macroeconomic policy; it is also used to assess the impact of expenditures. Overall utilization of the technique has been rather limited</td>
</tr>
</tbody>
</table>

| Weighted budget balance approach | Weights are attached to various types of revenue under assumptions of incidence and shifting of taxes to measure their first-round impact on GNP | Weights are also attached to categories of expenditures to assess the first-round impact on GNP and direct effects on balance of payments | Overall borrowing and their implications to cash management. A general rule of thumb for those engaged in fiscal policy formulation | This approach is used in formulating econometric models to ascertain the directions of macroeconomic policy; it is also used to assess the impact of expenditures. Overall utilization of the technique has been rather limited |

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<tbody>
<tr>
<td><strong>Cyclical measures</strong></td>
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<td></td>
</tr>
<tr>
<td><strong>Full employment surplus budget concept</strong></td>
<td>Projects tax revenues on the basis of actual effective tax schedules implicit as shares of GNP at full employment, which is defined as a constant rate of employment at 4 percent of the working force</td>
<td>It is assumed that expenditures will not vary much except for unemployment compensation corresponding to the full employment of labor</td>
<td>Full employment surplus represents the difference between estimated full employment revenue and full employment expenditure. Change in balance is used as an indication of cyclical impact of fiscal policy</td>
<td>The concept is used primarily as a presentation device and to demonstrate the need for cyclical deficits. The concept is not used for medium-term fiscal planning in the United States</td>
</tr>
<tr>
<td><strong>Cyclically neutral budget concept</strong></td>
<td>Cyclically neutral revenue is calculated by multiplying the base year ratio to actual GNP and then multiplying the subsequent actual GNP values by the same ratio</td>
<td>Cyclically neutral expenditures are calculated by multiplying the base year ratios of expenditure to potential output</td>
<td>Actual government expenditures are considered to be neutral when they remain constant as a ratio of potential output or GNP capacity. The neutral balance is one where the share of actual government expenditure in potential GNP and the ratio of tax revenues to actual GNP are the same as in a base full employment equilibrium year (1966). The main objective was to restrain the growth of expenditures</td>
<td>The concept is used for informal policy guidance in the Federal Republic of Germany but has no official sanction</td>
</tr>
</tbody>
</table>
Structural budget margin

Projections made on the assumption that revenues would show the normal rate of growth if output grew on a specified path. The margin is equal to the expected GNP trend-based growth of tax and nontax revenues.

Expenditures are estimated to grow at the same rate as structural GNP.

Tax revenues increased by inflation are to be partly neutralized through partial indexation of income tax. The remainder of the margin is to be used for increasing expenditures or for reducing tax rates.

Primarily used in the Netherlands, the norms for the margin were derived from a base year in the mid-1960s when employment, investment, and balance of payments were considered inappropriate for the current situation. The use of the concept was given up during the late 1970s in favor of a macroeconomic forecasting model, but it was revived in 1980.
The primary need of developing countries is often interpreted as the measurement of the growth impact of the budget rather than the liquidity impact. This aspect is, however, not served by the current account surplus concept. Measurement of growth lies in the impact of the outlays in different growth sectors, which cannot be fully reflected in income-based measures such as national accounts. To compensate for this, efforts are being made to evolve a series of human, economic, and social indicators to reveal nutritional levels, education, housing, water supply, sanitation standards, and life expectancy. These aspects concentrate on the outcomes of government expenditures, the measurement of which is, however, appropriately a part of performance budgeting. The development of economic analysis in developing countries is contingent on up-to-date national income accounts and priority must be accorded to that.

34See Norman Hicks and Paul Streeten (1979), pp. 567-80.
35National income analysts suggest that national incomes of developing countries are often understated. Implicitly, this may overstate the extent of fiscal impact. In the short term, adjustment of this factor depends on the policymaker’s judgment.
CHAPTER FOUR

Approaches to Decision Making

"If everybody minded their own business," the Duchess said in a hoarse growl.
"the world would go round a deal faster than it does."
LEWIS CARROLL, Alice's Adventures in Wonderland

The economic aspects of budget formulation analyzed in the preceding chapters emphasize that, if information and communication are present in the required degree, appropriate decisions seeking to maximize the community's welfare can be made. Indeed, in an ideal world, where these conditions are met, there would be no need for a distinct class of decision makers because decisions would be automatic and self-evident. Reality, however, is far different from the ideal situation. As intangible factors disrupt the causal chain of action, events may take place largely through chance. Perception of events may differ, depending on the intuitive grasp, timing, or the objective framework of decision making. Therefore, considerable problems arise in making the transition from theoretical abstraction to hard reality.

It was noted earlier that budgeting has been viewed as an optimizing process, as an externally determined event, and as a bureaucratic process. Because theories and considerations of decision making have naturally followed these approaches, it is appropriate to consider them in the light of certain preliminary factors. First, it must be recognized that decision making is primarily an art. Although some of the theories reviewed here were not specifically advanced in regard to budget making, some of their general postulates are relevant. Theories emanating from economics are essentially normative and global in their approach. To that extent they may have only limited application to budgetary decision making, but the underlying universal theme needs to be recognized. Second, the relevance of the
theories is considered not only in terms of human nature but of an organizational process comprising a set of explicitly defined, coordinated, and independent activities for achieving certain goals. Organizations are in constant interaction with their environment, receiving input and feedback and affecting the environment with their output. Specifically, budgetary decision making implies an adversarial process in which spending agencies advocate policies that are then reviewed by the central agencies responsible for the utilization of resources. Decisions in regard to allocations may not, however, be neatly categorized in the practical world. Spending agencies, central agencies, central banks, international aid institutions, and trade unions within a country have direct, formal, and informal influences on decision making and, in the final analysis, it is not always possible to show the precise contribution of each. The government has, like most other organizations, a definitive time frame for making decisions. In arriving at these decisions, participants adhere to a standardized code of behavior. No agency may depart from the code and disregard the controls; if all participants did this, there would be chaos. In government, like any other bureaucracy, definite functions, responsibilities, and budgetary and financial management procedures underlie the rules of the game.

Although the budgetary process provides standardized procedures, decision making itself is a creative process, with properties and features that are not contained in any single discipline. It is essentially a composite theme, elements of which appear as a part of economics, political science, psychology, and public administration. A neat classification of the approaches into these disciplines is a risky venture because the same general themes occur in all fields. In the following discussion, therefore, labels are used primarily for analytical convenience and a few theories are necessarily oversimplified. A detailed discussion of these theories is outside the scope of this chapter, but it is appropriate here to examine their relevance and to inquire whether they fully explain the nature of decision making and the problems faced in the process and whether they can offer a framework within which solutions can be envisaged.

1 An individual's decision making is studied as a part of psychology, while an organization's decision making is analyzed as a part of management or public administration.
During the early period of the growth of budgeting, the primary concerns of decision making were the relations between the monarchy and the legislature and the attempts of the latter to gain control of the former. As central agencies became established for control of expenditures within government, a heuristic approach governed budget making, reflecting primarily the a priori assumptions of policymakers and their explicit valuations. As a part of this philosophy, the "candle-ends" approach emerged, with emphasis on a restricted discipline dealing with a limited number of concerns relating to expenditure ceilings for government agencies and to their spending in a regular and economical manner. With the growth in expenditure, emphasis was increasingly placed on management, which was concerned with the selection of the best method for accomplishing a prescribed task. Later, with continued growth in expenditure, budgetary decision making extended its concerns to a host of issues relating to the long-range goals and policies of government and their relationship to specific expenditure policies. This growth in the range of decision making indicates a reciprocal relationship between needs in the practical world and the theoretical responses to these needs.

**Rationality Approaches**

The first stage of financial decision making, as stated above, was essentially heuristic, with concern for regularity and economy. Apart from the difficulty of providing precise definitions of budgetary terms, it also had the potential implication of different interpretations of what is regular and economical and, in the absence of clear evaluative machinery, decision making tended to be arbitrary. The inherent need was to move from a simplistic approach to a more definitive evaluation that would offer a better basis for decision making. In order to provide the machinery for such evaluation, the classical postulate of the "economic man" was developed for explaining and predicting the behavior of decision-making agents. The theory of the economic man merely states that, as an individual, man would act rationally and seek to maximize his utility or welfare. It was assumed that he would have knowledge of all relevant aspects, be well organized, have a stable

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2For a more detailed discussion of this growth, see Allen Schick (1966), pp. 243-58.

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system of preferences, be fully aware of the alternatives available to him, and be rational enough to calculate the course of action that would enable him to reach the highest point attainable on his preference scale. This simple theory, however, raised a number of issues, including its practical relevance. Studies of it took two different approaches—the analytical limitations of the theory and its practical limitations when applied to firms or large organizations.

Both these strands of thought owe a large debt to the pioneering studies by Simon. Specifically, in regard to budget allotments, Simon refers to his study of the public recreational facilities in a city where these were jointly managed by the board of education and the public works department. Although the two agencies agreed on the overall objective of the program, they disagreed on the more substantive issues, with the public works agency feeling that the playground was a physical facility and the board of education feeling that it was a social facility. This difference in the perception of the role of the recreational facility led to disagreements in budget allocations. If the rational theory of behavior was to be the guiding spirit, it was to be expected that these differences would balance off the marginal return of one activity against the other, but their persistence implied that the rational model of behavior had limitations. What factors would better explain the agencies’ approaches? How do they view efforts at finding solutions?

The rational theory was found to be inadequate in these respects. The assumption that the economic man is perfectly rational and that he will assess all alternatives himself becomes debatable. In reality, he is hemmed in by uncertainty, expectations, and imperfections, and it is likely that when he reaches an alternative that is satisfying, he will refrain from further search and analysis; his knowledge or rationality is therefore not comprehensive but is bounded. In a framework of bounded rationality, as distinct from complete rationality, the individual may replace global goals with more tangible subgoals permitted by his process of search and identification. In an organizational context, this could imply that the tasks of decision making would be divided among many specialists and that each task would be

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coordinated within organizational, hierarchical, and other relationships. Simon's main contention is that perfect rationality is a myth, is contrary to fact, and does not explain how decisions are made in the real world. In a positive way, the concept of bounded rationality seeks a more realistic formulation of the limits of knowledge and the human capability of comprehension. It seeks to provide a link of economic rationality with the day-to-day working of large administrative organizations by formalizing and specifying the limitations of the classical theory. But in terms of applicability, both have the same limitation because no mechanics are offered for making a decision. Both, however, provide greater insight into human behavior.

Similar theories have been advanced in regard to the firm and larger organizations. Several theories on the behavior of the firm were presented by Simon, Cyert and March, Penrose, Baumol, Morris and Williamson, and others.\(^4\) Cyert and March,\(^5\) whose approaches are relevant here, basically exemplified Simon's postulate that, under conditions of uncertainty, the firm, while behaving rationally, will "satisfice" rather than "maximize." Their theory lays stress on the group of individuals that are responsible for setting goals for the firm and for resolving conflicts that may arise. The individuals, it is suggested, may form coalitions, in which their conflicts are resolved through mutual accommodation. Demands may be made in the organization sequentially rather than simultaneously. The primary tasks of individuals in the firm are to set goals for production, inventory, sales, market share, and profits. When resources are not adequate to meet the demands of the coalition groups, an organizational slack emerges, representing the gap between available resources and those necessary for meeting demands of the coalition groups. Cyert and March observe that the organizational slack acts as a cushion during resource shortages and that a search is initiated for finding methods of saving. The slack may not be created deliberately but may occur naturally and it acts as a stabilizing influence at all times. Cyert and March suggest a framework of four concepts that could serve as a basis for resource allocation within firms and nonbusiness organizations: (1) quasi-resolution of conflict through subdivision of goals and

\(^4\)For a brief discussion of some of the behavioral theories of the firm, see Aubrey Silberrson (1970), pp. 511-82.

problems, with emphasis on a limited number of problems through
the use of acceptable decision rules rather than optimization;
(2) avoidance of uncertainty through tackling problems as they arise by
resorting to feedback of information and by negotiating decisions
under standard procedures; (3) problemistic search for solutions to
problems as they are encountered, with the search itself being a simple
model of causality; and (4) organizational learning, implying adapta-
tion through experience and search rules. Goals are changed in light of
the experience of similar organizations and the history of the industry.
Specifically, in a context of severe resource constraint on budgeting,
Cyert and March suggest that there could be two reactions: (1) a
tendency to use arbitrary rules for allocation that maintain the status
quo among members of the coalitions; and (2) a tendency to re-evaluate
proposals that are difficult for the members to accept. In budgetary
language, this implies that the budgeteer would attempt to maintain
the balance between competing demands and that the participating
agency would try to reappraise its proposals in order to make them
more acceptable.

The framework set forth by Cyert and March follows the traditional
theories of organization. The "rational" or utility-maximizing decision
approach to organization of the classical economists implies a complete
control of variables and a closed system to achieve such control. The
"natural" or "satisficing" approach reflects an open system strategy.
Both systems pursue efficiency as it is defined in a broad or narrow
way. The rational model stresses allocative efficiency, while the natural
style recognizes the impact of exogenous factors on economic policy,
with particular emphasis on bounded rationality and on decisions that
tend to satisfy rather than to maximize. In a natural system, the
decision maker has to accept greater uncertainty, as he does not know
all the variables. In such a context, parts of an organization may pursue
different goals and dysfunctional behavior may result. Some balancing
takes place in the system because some agencies are specifically
entrusted with coordination. The natural approach deals with senti-
ments, self-striving groups, and responses to problems. Rational
systems see organizations as vehicles for rational achievements, while
the natural style stresses the behavioral characteristics, interacts with
the outside world, and welds the different elements within the
organization into a meaningful whole. In reality, however, the
difference between rational, self-stabilizing organizations and prob-
lem-facing and problem-solving organizations is in the acceptance of knowledge and in the formal recognition of environmental factors.

The framework of Cyert and March was tested primarily at the level of local governments in the United States and in Norway. The tests reveal some common features. They show that (1) some elements of the budgets are quite stable while others are volatile and contentious, (2) revenues are usually understated, and (3) conflict in regard to continuing expenditures can be avoided by a renegotiation of previous programs while new outlays are resolved in a bargaining process. The study on Norway by Cowart and Brofass attempts a broader canvas, examining the behavioral patterns at four levels—agency request, departmental review, recommendation of the executive, and approval by the council. It reveals that the perceptions at each stage are different, as each level constitutes an exogenous variable to the previous one.

Although these studies demonstrate some features of budget decision making, they also have limitations, some of which emanate from Cyert and March's framework. The goals at various levels may not be independent nor are they mutually compatible. The influences of the market on decisions are isolated and different responses to the same stimuli are not given due weight. Besides, there are inherent problems in extending the analogy of the firm to government. Coalitions may not be formed in government civil service because of the nature of civil service and, as indicated later, in a resource-rationing context formation of coalitions is a zero-sum game. Government goals tend to have some stability, while those of the firm change faster. The government budget is not decided by a single administrator but is completed through a series of processes under rules known to the participants. The budget is viewed narrowly in these studies, for the primary purpose of distributing funds and establishing administrative tranquility. Economic goals, recognized priorities, and other important functions of the budget are not explicitly identified in these models. Specifically, in regard to developing countries (or for new firms), where resource uncertainty is greater and where organizational slack may not be evident, the major issue is whether problemistic

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search would continue to be short-term oriented or would lead to the introduction of organized planning systems (as, indeed, has been the case) to anticipate problems and to respond to them.

ADJUSTMENT AND STEP APPROACHES

Introduction of planning, however, revives the issue of rational approaches that emphasize the application of analytical criteria to resource allocation by a deliberate examination of a wider range of alternatives. Extending the Simon approaches, Lindblom believes that a comprehensive attempt at problem solving through planning is not possible to the degree that clarification of objectives founders on social conflict, that required information is either not available or will entail prohibitive cost, or that the problem is too complex for the decision makers' intellectual capabilities. In Lindblom's view, the alternative consists of disjointed incrementalism, which also was known as "muddling through" or "partisan mutual adjustment." The concept of Lindblom's incrementalism is to be distinguished from a more empirical form of incrementalism discussed later in this chapter. The major elements of Lindblom's approach comprise (a) the difficulties in the application of comprehensive or rational problem-solving approaches, and (b) the specification of ends and means, and his alternatives that favor the adoption of incrementalist approaches and the process of adjustment in policy formulation. His concern, like Simon, was in establishing the limits of the comprehensive or rational approaches emerging from the cognitive capabilities of the decision maker. To him, the rational approach of adjusting the means to the end is not feasible. Policy decisions affect different values so that there are conflicts at every stage, and as each decision is saturated with value choices, it would not be possible, or politically feasible, to maximize social welfare. An alternative is to choose the end and the means simultaneously rather than to choose the means after choosing the end. Lindblom contends that movement toward decisions should be by small steps, because comprehensiveness, apart from not being feasible, could accentuate conflict. Finally, it is suggested that fragmented policymaking, which exists in a system with a very large number of

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separate points, will also facilitate acceptable decision making through a process of partisan mutual adjustment, when the process is viewed as a whole in its political or social context, even if it is not complete at different points of policymaking.

Similar themes are seen in the approaches to economic development, particularly the views of Hirschman and the approaches of some analysts to research and development. Hirschman doubted the feasibility of balanced growth as a meaningful objective and felt that the resources of the economy, at any point of time, are not to be considered as rigid and that more factors of production come into play if development is marked by sectoral imbalances that galvanize entrepreneurs into action. The critical assumption in this approach is that there is a “slack” in the economy that can be harnessed through various uncoordinated pressures. Hirschman in 1960 speculated that such a process could lead to a faster achievement of the development goal, and later developed this into the principle of “hiding hand.” Around the same period, Klein and Meckling argued that research and development would be less costly and faster when marked by duplication or lack of well-developed coordinating mechanisms. The common point with Lindblom in these approaches is that a system is never complete and therefore not much is to be gained by seeking an integrated whole. Implicit in this is also the assertion that the natural or uncoordinated rate of growth is higher than the warranted or planned rate of growth. These writers attack the values of planned orderliness, and they believe that inaction or a “wise and salutary neglect” might be appropriate. The reasons for attacking rationality or organized planning are, however, different for each. To Lindblom, it is complexity and man’s inability to comprehend; to Klein and Meckling, it is future uncertainty; and to Hirschman, it is inadequacy of incentives to solve problems or of ways in which the slack could be harnessed. There are differences, too, in that Hirschman’s concern is with central planning and the central planner, while Lindblom’s concern is with a decision maker who is also engaged in partisan adjustment. Their main convergence is on what they describe as the “unquestioning intellectual allegiance” to traditional theories.

8 See A. O. Hirschman (1958). These common points were elaborated in a joint paper by A. O. Hirschman and Charles E. Lindblom (1960).

9 Hirschman and Lindblom (1960).
An attempt was made by McKean\(^10\) to integrate the rational approaches with the bargaining or mutual adjustment approaches. In McKean's view, the two would realistically condition each other. Extending the political or bargaining approaches (at any level) and the invisible hand approaches of Adam Smith, McKean formulated the principle of the "unseen hand" in government.\(^11\) Under this approach, every decision maker is regarded as a utility maximizer and also one who perceives and weighs the costs and benefits accruing to a community from his actions. As decisions are also political, involving bargaining among groups, it is to be expected that utility maximization approaches, together with bargaining, may result in a sensible resource use. The bargaining mechanism is the "valuable and unseen hand" guiding resource utilization, and its advantages lie in curbing the excessive zeal of decision makers and molding the parochial views of officials into harmonious and beneficial patterns of action.

The main difference between the two broad schools of thought of rationality and partial adjustment is that the former emphasizes the deliberate examination of a wide range of alternatives, while the latter believes that the attention of the decision maker is on the immediate problem of increases in the budget, with only a small number of alternatives (if any) to be considered. The other differences are summarized in Table 9. The theories reviewed suggest that the rational approach has comprehensiveness as its ideal. Although this ideal is difficult to attain, the alternative cannot be the paradigm of adjustment. Rationality is something that a decision maker seeks, and his process of reconciliation with feasible alternatives may be to accept

\(^{10}\) Roland McKean (1968).

\(^{11}\) As a variation, Hirschman (1967) formulated the principle of "hiding hand," according to which decision makers venture into new realms and "tasks because of the erroneously presumed absence of a challenge, because the task looks easier and more manageable than it will turn out to be." It implies that actions are taken through ignorance of uncertainties and difficulties but the "hiding hand" is helpful in that each situation will come into the world with a set of unsuspected remedial actions that can be taken should a threat become real. Hirschman sought to illustrate this principle with reference to selection of projects whose costs are initially underestimated and investment decisions activated in consequence. In essence, Hirschman hopes that each decision also has a slack that is useful during critical periods. Most decision makers share Hirschman's optimism. Most budgeteers find that the "hiding hand" rarely comes to their rescue. Indeed, reliance on the principle may aggravate the financial situation.
Table 9. Rationality and Adjustment Approaches

<table>
<thead>
<tr>
<th>Lineage</th>
<th>Type of approach</th>
<th>Criticisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional economic theories</td>
<td>Emphasis on objectives and appraisal of alternatives in the light of objectives</td>
<td>Survey of alternatives is not feasible. Comprehensive decisions would minimize partisan adjustments and fail to receive political approval. Conflict can be reduced by reducing specification of objectives and by taking small steps</td>
</tr>
<tr>
<td>Pluralist concepts of democratic government</td>
<td>Process of adjustment among individuals and groups that have differing values and degrees of power</td>
<td>Bargaining could lead to discussion of wrong issues; wide differences in bargaining power may result in inadequate power for taking relevant action. Existence of countervailing power may reduce benefits to common interests. There may be no substitute for analytical criteria to determine government expenditures</td>
</tr>
</tbody>
</table>

bounded rationality. The imbalanced theory of growth and the mutual adjustment approach are partly speculations that cannot always be empirically tested; they offer an explanation for behavior but do not set a pattern for it. Their contributions lie in being heretical and in questioning dogma that needs questioning. But their alternative, in the form of bargaining, has also serious limitations, which, as discussed in the next section of this chapter, induce game behavior, and situations may emerge that are not conducive to welfare.

Even within the limited parameters of adjustment approaches, and particularly in their application to budget making, it has to be recognized that incremental decisions anticipate fundamental decisions and that the sum total of incremental decisions is subordinate to a framework of fundamental decisions. It can also be argued that, given

the complexity of governmental tasks and their management, neither the fragmented, sequential steps of adjustment nor rational approach will suffice and an interdisciplinary framework may be needed. While the need for such an approach is more apparent in the light of other problems that are discussed later, it is also clear that rationality must be tempered by political and other bargaining processes in the real world. Conversely, bargaining itself cannot be relied on exclusively and needs a negotiating framework, which, in turn, is influenced by rational and bargaining approaches. Decision making as an art is based on a natural-rational ("naturational") style—one that recognizes goals, strategies, and exogenous factors. But the recognition of these factors may induce certain patterns of behavior that become evident when budgetary decision making is viewed as the resolution of conflicts.

**CONFLICT RESOLUTION**

A general issue that is often raised in describing the antagonistic process of budget making is whether it should be considered as a tension-generating or conflict-generating atmosphere. The difference between the two is obviously one of degree. When tensions are deep rooted, they become conflicts. It is generally viewed that conflict is natural in a process where the spending agencies are keen to obtain greater allocations to pursue their tasks and where the role of the central agency is precisely to keep the increased allocations within the available resources. Although it is not always true, central agencies feel that the spending departments do not give proper attention to the need for economy and vigilance in financial management procedures. Indeed, in describing these relationships, many draw parallels with Don Quixote and Sancho Panza. Where Sancho Panza saw windmills, Don Quixote saw wicked giants. Similarly, it is argued that where the spending agencies see a unique opportunity to further their policy objectives, the Finance Ministry may see an unproductive outlay. While these analogies tend to draw exaggerated pictures, the fact remains that spending agencies are advocates of policies that contribute

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to increased fiscal burdens. The role of the central agencies is not to dampen enthusiasm but to use discipline to prevent imbalances and extravagances.

If the budgetary process brings conflicts into sharper focus, efforts are needed to contain these conflicts and to channel them toward constructive action. Approaches to conflict resolution or containment include political, administrative, psychological, and economic considerations. At a political level, since most allocation decisions are recognized as political, doctrinal agreement or an accepted political strategy would facilitate the reduction of conflict. While, in an ideal two-party system, this has greater prospects, in practice it may have limitations. It is likely that a coalition is in power, in which case political conflict becomes an enduring feature of budgetary decision making. Budget policies, particularly in regard to allocations, may not, however, be very different among parties. Even where differences are pronounced, they may be at the level of a function while, at a program level, decision making may continue to be dependent on objectivity, felt needs, and bargaining. But in situations where single-party dominance is traditional and where doctrinal agreement is the basis, as is the case in centrally planned economics, conflict may not emerge in any significant form.

Another form of conflict resolution is a process of consensual validation. The experience of Japan, Saudi Arabia, and a number of other countries reveals that parleys are held between the finance and spending agencies, and the proposed courses of action (including the allocations to be made in the budget) are discussed at official and political levels and the majority view is taken as the basic approach. The committee approach (for example, the Public Expenditure Survey Committee in the United Kingdom) to determine budget signals, or to review budget estimates and procedures relating to budget hearings, facilitates a consensus. The committee approach is operationally convenient for consensus building, information distribution, strategy mapping, simultaneous participation of all concerned, and fast in reaching decisions.

The psychological approach to conflict resolution stresses three methods: (1) fights, where the objective is to harm or destroy the opponent; (2) debates, where opponents direct their arguments at each other for the purpose of convincing the other; and (3) games where the
attempt is to outwit the opponent. The difference between fights and games is that in a fight the intention is to harm the opponent, in a game it is to outwit the opponent. In debates, the techniques of fighting (thrusts and threats) or of games may be used, but their value is determined only by the final results: Is the opponent convinced? Fights, although rare, are found in practice. Several cases are to be found in Western democracies where the choices between public ownership, provision of social services, and levels of taxation have contributed to bitter governmental fights. Within governments, however, the process of discussion may not culminate in a fight; if it does, one of the parties is likely to lose not only for the present but also partly for the future. Debates are more frequent and, in recent years, the public has been encouraged to participate. Advance publication of medium-term plans and related scenarios is now the practice in a number of countries to promote an orderly debate.

The game theory has been well developed in economics during recent years, essentially to reflect rational decision making in situations involving conflicts of interest between two or more parties. It devotes proper weight to strategic decisions or to those that are contingent on the actions of others, which, in turn, are based on one party's responses. The game theory requires that the actors and their possible actions be explicitly recognized, along with their mutual interdependencies. It postulates that each individual is not only conscious of his own requirements but is also aware that the other parties are equally conscious of theirs. Games are considered in terms of zero-sum games, in which one player's losses are equivalent to the

14See Anatol Rapoport (1963). Similar approaches are evident in management science. For example, Mary Parker Follett, one of the pioneers in management science, observed that there were three ways of resolving a conflict: domination, which implies victory by one side; compromise, reflecting a partial surrender of what is wanted by each side; and integration, representing a search for a new solution that would satisfy the real needs of both sides. It was recognized that domination would result in defeat of one side, leaving the party to resume the conflict. Compromise is unsatisfactory; what is surrendered depends on the relative roles and strengths of the contending parties. Initially, this could lead to the overpitching of demands. Integration is considered more appropriate, as it signifies a revaluation through (a) breaking down demands into their constituent parts, (b) examining the real meaning of symbols, and (c) preparing for the response of the other side. This approach has the potential of bringing about unity from conflict, although it is by no means easy to achieve.
gains of the other, and nonzero-sum games, in which some outcomes are preferred by both sides. In considering the relevance of this approach to budgetary decision making, it is to be recognized that the game strategy implies a basic conflict. But is this so? Government effort is perhaps better seen as a cooperative effort, in which some conflicts arise, rather than, as in the prisoner's dilemma, an effort in which parties have been detained separately and kept guessing about the motivation of others. Also, if game theory is strictly applied, it leads to a game trap from which no meaningful policy solution may emerge. A distinction may therefore be drawn between cooperative and noncooperative games. Cooperative games are those in which the participants come face to face, communicate, and decide before agreements are made public. Such a cooperative game in budgetary parlance may involve bargaining, and agreements can be arrived at through a sequential approach, with a minimal specification of objectives, and through movement by small steps, as advocated by Lindblom. Bargaining is the process by which the outcome is determined in a cooperative game that has no unique point of reference.

In day-to-day budget decision making, the role of bargaining within government and among contending parties has grown somewhat during recent years, as is evidenced in the number of lobbies, reflecting the perception that budget policies, including allocations, can be manipulated. The use of bargaining strategy itself, however, contributes to distortions in budget making. Bargaining, unlike game theory which implies complete specification of the relevant elements, leads to incomplete or partial revelation of information—for example, understatement of revenues or exaggeration of tax intentions to leave a margin for negotiation. Bargaining implies more than one step in the process, and in each stage additional information may become available. Also, when bargaining becomes too insistent or tends to become deeply ingrained, escape mechanisms may emerge and key policy variables may shift outside the budget.\footnote{This may lead to extensive earmarking. In Japan, where bargaining takes place in respect of the main budget account, greater controls are exercised by the Finance Ministry on the Fiscal Investment Loan Program, involving substantial borrowed funds and outside the traditional budget.} Bargaining also has several undesirable effects. Its outcome becomes unpredictable and

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often leads to the elimination of the potential gain that is the object of bargaining.\textsuperscript{16} When information is distorted, decisions could be delayed, resources could be wasted, and frequently the bargaining machinery breaks down and the art of compromise may lead to a compromise of the art. Short-term expedients emerge and problems that are postponed appear again after a gap. In due course, the problems become chronic and are beyond the normal budget framework. Games and bargaining tend to shift the emphasis from the play to the players, and the play itself may suffer, although the player may survive and may even win accolades before the nuances of the play come to be realized.

It is appropriate to examine how conflict is sought to be contained in the budgetary process. Caiden and Wildavsky,\textsuperscript{17} who have made a study of the problems in poor countries, suggest that conflict resolution is accomplished through strategies that are essentially escapist in nature. According to them, the approaches are (a) to satisfy everybody, i.e., all budget requests would be met by providing some amounts to those that demand them; (b) to spread funds around, i.e., provide at least a part of the amount, even if the projects or programs become too expensive later; (c) to postpone the evil day; (d) to be vague; (e) to limit participation; (f) to do what was done before; and (g) to say the budget works on paper. While these approaches are not universal, they appear to reflect the information gap in the bargaining process and the general reluctance to decide. They reflect, in part, the inability to estimate the future and, in part, failures in certain areas of budgeting. They cannot be considered as approaches to decision making unless the approach itself is not to make a decision. Shortsightedness is often incidental rather than a deliberate posture and, in any event, it does not carry much conviction in organized planning that provides the framework for decision making.

\textbf{Operational Aspects}

The regular experiences of budgeteers and their approaches to decision making have also contributed to the formulation of theories

\textsuperscript{17}Naomi Caiden and Aaron Wildavsky (1974), pp. 207–39.
and behavioral patterns. Wildavsky, extending and formalizing the small-steps approach of Lindblom, contends that budgeting is basically incremental and that budgeteers are concerned with small increments to an existing base. Offering empirical support, he suggests that the smaller the change in the budget, the more a budgetary process would be described as incremental. As a part of the framework, incrementalism is considered to be most evident when requests for funds at the previous year’s level would generally be acceptable to the central agencies. While the approach has considerable validity for explaining some budgetary shortcomings, as a determinant of budgets and as a norm of the decision-making process it raises serious controversies. Experience of recent years suggests that funds are budgeted not only for the forthcoming year but over a medium-term period, based on a conscious and deliberate economic strategy that may involve increases and sizable reductions. As noted in Chapter 1, the problem of financial management is perceived in many countries in terms of bringing about a sharp reduction in the budget. Budgetary changes can therefore be volatile rather than show a secular trend of small annual increases. Specifically, in developing countries, budgets for development plans show substantial annual changes and, in any event, an important part of the budget is for new outlays. Problems arise in the empirical verification of the concept, because the initial small steps may be in anticipation of enhanced supplementary appropriations. Also, incrementalism refers to aggregate changes, which (even when they are stable) could imply a changed distribution of resources among the units. The important issue for decision making is not merely the aggregate changes but the way in which they should be allocated to the participants in budgeting. Incrementalism basically reflects a reluctance to face the economic realities, and the fiscal experience of industrial and developing countries suggests that the problems of budgeting and the approaches to decision making are too complex to be captured in the limited incrementalist approach.

The operational approaches to decision making and some of their shortcomings were considered in the previous chapter. On a broad scale, however, it appears that budgetary processes aim at rationality; but in their operation, the choice of approaches is guided by

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18 Aaron Wildavsky (1964).
feasibility, practical convenience in terms of monitoring developments and related feedback, and, above all, transaction cost. Development of an ideal, in whatever form it is envisaged, may imply enormous expense and time, and the results may not be commensurate to the effort. Reliance is therefore placed on what is feasible within the framework of time, cost, and administrative capability—all illustrating decision making through search and analysis within the framework of bounded rationality. A major shortcoming of the theories is the inadequate recognition of systems of values that pervade budget operation. The systems of values found in industrial and developing countries imply dichotomous approaches. In industrial countries, primary decision making about expenditures may be between those for defense and nondefense, those that are controllable and uncontrollable, or (as in the Netherlands) those that are relevant and other expenditures. In developing countries, the choice may be between plan and nonplan expenditures or in terms of development and nondevelopment expenditures. With such classifications, the inherent values or priorities come to be superimposed on decision making so that it may become rigorous or lax, depending on the status accorded to these priorities.

The experience also suggests that budgetary decision making is often influenced by selected key variables. Ratio of the deficit or surplus to GDP, the domestic borrowing requirement, whether to borrow from the central bank or from abroad, and the import content of the budget are some of these key operational variables. The selection of the variable is dependent on the country’s economic policy goals, and the success of the instrument chosen is dependent on the viability of the policy goal itself.

Thus, it appears that the theories discussed deal with general issues and, when applied to budgetary decision making, fall short of capturing reality and offering a scientific method for the decision maker. Also, descriptive theories help to explain some patterns of behavior but lack predictability. Experience with budgetary decision making suggests that it is both political and administrative at the highest level, i.e., goals, but at the stage of program allocation it must take into consideration resource constraints, objective criteria for evaluation, cooperative games, and bargaining. Within the narrow categories of programs, however, collective decision making takes place according to rules.
CHAPTER FIVE

Organizational Aspects

... and they don’t seem to have any rules in particular; at least, if there are, nobody attends to them....
LEWIS CARROLL, Alice's Adventures in Wonderland

The previous chapters have been devoted to a consideration of theories and practices of budgeting. The success of budgeting as a system is crucially dependent on several organizational factors and on the attention paid to vulnerable areas. The first part of this chapter considers organizational aspects and the second part is devoted to a discussion of selected problem areas.

FEATURES OF BUDGETARY SYSTEMS

Financial management structures and related styles of administration have considerable influence on the actual working of budgetary mechanisms. In addition to providing an insight into the working of the institutions, the systemic features are of importance in assessing the cognitive abilities for identification, anticipation, and measurement of the fiscal issues. Budgeting, which initially reflected the legislative and executive relationships (and the efforts of the former to gain control over the operations of the latter) went through several stages of development, each leading to the succeeding one and resulting in a cumulative experience for those responsible for government finances. Budgetary systems do not necessarily imply rigid or established patterns, but over the years some broad groupings have

1 Unlike systems, styles of management do not lend themselves to neat classifications. There is little empirical work in this regard and what is available is mostly anecdotal in nature. For an attempt at analyzing the approaches to economic research (which need not necessarily influence the management style), see Harry Johnson (1973).
developed that reflect common constitutional, legal, and administrative heritages. There are severe constraints in describing these types of budgetary systems because they have undergone many changes since the 1950s and distinctions between them have become blurred. Distinctive features of any one type may not be found in their entirety in one country, as several variations of the same practice are to be found. Also to be noted is the modernization of systems on different patterns by countries that originally started with the same type. Modernization might imply that the traditional systems have been discarded, but in practice few countries have totally discarded theirs; even where new techniques are introduced, the basic framework continues. The frequent changes may also imply that some of the features described here may not be found in that format.\footnote{There is not much literature on changes in a country’s budgetary system, but evidence of changes may be found in studies done at different times. For European countries, see, for example, United States, Staff Papers and Other Materials Reviewed by the President’s Commission (1967b). For studies of the United Kingdom, the Federal Republic of Germany, France, the Netherlands, and Sweden, and for a later view on the same countries, see United Kingdom, Memoranda on the Control of Public Expenditure (1978a). For a description of the European countries, see also David Coombes (1970).} Also to be noted is that different terminology is used to describe the same process in various countries. Despite these difficulties, six broad types of budgetary systems can be distinguished in terms of their approaches and influences.

1. Among the original influences were the British type of budgetary system and the French financial management system. British budgetary procedures, which evolved over a long period, reflect empiricism and pragmatism. Although the United Kingdom itself had few budgetary laws,\footnote{Molonier points out that, like other British institutions, its budgetary system was not founded “on the Cartesian principle tabula rasa. In this sense, British budgetary laws faithfully reflect the British mentality: the idea of system is alien to it” (see his contribution in David Coombes (1970). It has to be noted, however, that what might have been alien in Great Britain came to be firmly organized in its colonies. Indeed, the financial system formed, in addition to law and order, the hard core of British rule.} its colonies developed budgetary laws that continue to govern the current practices in several Asian, African, and Caribbean countries. The British type of budgeting largely consisted of a consolidated fund through which all revenues and expenditures
flowed; and budgeting was undertaken primarily on the expenditure side, totally separated from the revenue side. The spending agencies were subjected to different degrees of control during the budget execution.

2. The French system, which is to be found in France's former colonies, is based primarily on two principles—a strong financial control system and a central treasury. The control system has three operational levels—comptrollers attached to spending ministries and overseeing their financial transactions, a cadre of public accountants responsible for the collection and disbursement of monies, and inspectors of finance having greater power and responsibilities and representing, as it were, the financial conscience of the Government as a whole. The French Treasury is not merely the cashier but also a banker. Its purview extends to acceptance of deposits from public agencies, in addition to normal treasury functions such as scrutiny of bills and payments. These twin features of the system are to be found in French colonies in Africa and Asia. Other African countries, such as Zaire and Rwanda, show strong similarities to the French system but are not fully comparable. Some of these influences, particularly those relating to expenditure control, are also to be found in the Middle Eastern countries.

3. A third group may be identified as the European systems. The major systems of this type are the Netherlands, Italian, and Portuguese systems, which are to be found in varying degrees in Indonesia, Somalia, and the former Portuguese colonies, respectively. These systems differ in several ways. The Netherlands system reflects greater reliance on the commercial principles of budgeting, including provision of depreciation allowances, and, until recently, accrual-based accounting. The Italian budgetary system shows the availability of funds beyond the fiscal year, with parallel operation of the preceding and current years' budgets and extensive controls by the Comptroller General. The Portuguese system relies more extensively than others on the legal approaches to budgeting and annual specification of budgetary allotments by law. Practices in the Federal Republic of Germany are not very different from those of other European countries; in any event, the German system did not have a significant influence on any other country.

4. The fourth type consists of U.S. practices, which are largely
centered around a general budget and numerous trust funds that are not subject to legislative approval. More recently, the U.S. Government has, for analytical purposes, followed a unified budget, combining the features of general administrative budget, the cash budget, and the budget based on national income accounts.

5. A closely related practice, but forming a distinct type, is the Far Eastern budgetary system, which is influenced by Japanese tradition. This budgetary system comprises a general account, several special accounts dealing with specialized and quasi-trading activities, and extrabudgetary accounts, of which the most important is the Fiscal Investment Loan Program, largely financed by borrowing. Budgets contain unconsolidated transfers from the general to special accounts. Similar practices are to be found in the Republic of Korea and, to a lesser extent, in the Philippines and Thailand.

6. The sixth category, although somewhat amorphous, is what may broadly be called the Latin American type. Latin American countries initially adopted procedures with a strong Spanish influence, developing in due course their own hybrid systems as a by-product of their administrative experience. The main features of the Latin American systems are extensive earmarking of funds, decentralization of government activities into autonomous agencies, reliance on a noncash basis, and combined accounting and audit machinery. Within these broad types of systems, various financial management practices have evolved. At the present time, several common practices and dissimilar features are found among countries.

Budget coverage differs from system to system. The primary differences relate to autonomous agencies, social security systems, and loans. In the U.K., European, U.S., and Far Eastern systems, budget coverage is fairly comprehensive. In the United Kingdom, it includes trading accounts and the coverage of the Public Expenditure Survey is even wider, including social security. Similarly, the American system also covers social security transactions, although, despite repeated attempts to the contrary, off-budget agencies have grown. In Italy and the Netherlands, the social security system is excluded. The Italian budget is limited to government departments only. The system in

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*The Philippine budgetary system was changed to a U.S. type in the early 1950s but retained in its fund structures some of the previous influences.*

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France has, however, undergone a process of "debudgetization," under which certain lending and credit transactions carried out by the Economic and Social Development Fund have been separated from the budget. Also excluded are social security, road development expenditures, transactions with the local government, and loans for housing. This debudgetization has had only a slight effect on the former French colonies. In Latin American countries, budget coverage is generally narrower than that in other systems. It also indicates that the terms "surplus" or "deficit" should be taken as relative and, in any event, their meaning is far different from the surplus or deficit of the consolidated public sector, whose operations are important in assessing the impact on the economy. In several developing countries, social security is treated separately, as are government loans and, in certain cases, grants and loans received by the government.

The budget structures in these systems vary from unified (or unitary) budgets to dual and multiple budgets. Budget structures are, however, considered in detail in Chapter 10.

A related feature that should be mentioned is the procedure adopted for budget implementation, pending approval of the budget by the legislature. In numerous instances, the budget may not be approved before the fiscal year begins. The need for funds in the American system is met through an interim resolution by the legislature, and in the British systems by a vote on account, under which a fourth of the funds sought are approved. In the Netherlands, Portuguese, and Latin American systems, while awaiting approval the executive is empowered to spend for each month amounts not exceeding those spent in previous years.

The basis of budgets also differs from system to system. In the U.S. budget system, the appropriation acts specify the new budget authority, while the basis of budget making is the cash outlay during the year, representing the actual and likely expenditures from the previous and proposed budget authority. The U.K. budgetary system is based on cash, as are the Far Eastern budgetary systems. The Netherlands system, which formerly emphasized the "acquired rights" basis of expenditures, has recently moved to a cash basis. The French, Italian, and Latin American systems base their budgeting on expenditure authorization, program authorization and obligations, or appropriation authority. Revenues are similarly distinguished—some based
on actual receipts and some on claims. In most systems, funds provided for the budget lapse at the end of the fiscal year. In the Italian budget, unspent and capital outlays and uncollected revenues are carried forward to the next and subsequent years. These constitute a parallel budget, as noted earlier. The amounts passed on (residui passivi) are fairly large, both in absolute amount and in relation to budgetary appropriations, but apparently have not led to major uncertainties in budgeting because both the amounts carried forward and the annual appropriations have remained stable.

Some distinguishing budgetary practices relate to borrowing. In the United Kingdom, until World War II, a legal limit was placed on borrowing, but this was later abandoned. More recently, however, borrowing became more important in the United Kingdom but has a self-enforced limit rather than a legal one. In several commonwealth countries similar limits are in force, but these are fairly flexible and are changed annually with the budget. The United States places a limit on government borrowing, while the Netherlands Government cannot borrow abroad to finance its budget operations. Differences are found in the inclusion of borrowing proceeds in the budget. In countries that have a legal requirement for showing balanced budgets, proceeds of borrowing are included on the revenue side of the budget. Indonesia, Japan, the Federal Republic of Germany, and the Philippines follow such procedures, while other countries show borrowing separately. In some developing countries, however, budgets may not reflect all government borrowings from abroad.

Another area in which differences have emerged relates to the use of policy budgets and concepts for measurement of the impact of the budget. These differences, however, do not reflect the budgetary system as much as they reflect the relative economic environment in which budgets are formulated. In industrial countries, as noted earlier, the legislative budgets, expenditure forecasts, and budgets based on national income are used for economic policymaking. Also, greater importance is attached, both in government and public policy discussions, to the amount of the budget deficit and the means of financing it. In the Federal Republic of Germany, the United Kingdom, and the United States, the budget deficit is a controversial political issue. To minimize public criticism, governments have on occasion attempted to conceal budget deficits through various ar-
rangements. In Italy, a budget deficit is less controversial because the exact dimensions of the deficit do not emerge clearly. In the Netherlands and Sweden, economic policymaking aims at containing the budget deficits as a ratio of GDP. In the developing world, including a number of Latin American countries, budget deficits appear to attract less public debate, partly because of the difficulties in computing their size. Also, inadequate development of statistical systems have thwarted the formulation and analysis of the government budget in national income terms.

**FISCAL YEAR**

Traditionally, the fiscal years of governments have evolved over the years and have been influenced by crop cycles, political factors, convenience, the tradition of metropolitan governments, and relationship to the financial years of domestic industries. During the past three decades, several industrial and developing countries have changed their fiscal years. The United States changed its fiscal year in 1974, while the Federal Republic of Germany and Italy changed theirs in 1960 and 1964. Egypt changed its fiscal year in 1980, while Pakistan, Papua New Guinea, and Sri Lanka changed theirs during the 1960s and 1970s. Most countries have fiscal years that are based on calendar years; some fiscal years begin in July, while a few begin in April. Some countries—notably Nepal, Oman, and Saudi Arabia—have a floating system, whereby each fiscal year is determined on the basis of the lunar or solar calendar. Saudi Arabia prepares the budget in terms of the Hijra calendar, while India indicates the equivalent of the fiscal year, as supplementary information, in terms of the Saka year.

Discussion on the appropriate period of the fiscal year frequently takes place, often with recommendations being made for change of the fiscal year. The arguments for change stem from a variety of concerns. From a policy point of view, it is suggested in some developing countries that the original fiscal years largely followed those of the

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5 See, for example, the report of the Indian Administrative Reforms Commission's Study Team, India (1966). An exception, however, is provided in the report of Lord Armstrong's Committee, *Budgetary Reform in the U.K.* (1980). After considering the issue, the Committee chose "not to take a position for or against it" (p. 16). C. Johnson (1980, pp. 29-30) argues vigorously for a change in the U.K. fiscal year.
metropolitan governments and did not reflect the economic cycle of their operations. In India, for example, the revenue outturn and the estimates of expenditures are partly dependent on agricultural expectations, which are better known after the monsoon during May, June, and July. However, as the fiscal year starts in April, following the convention of the United Kingdom, the budget was always highly tentative and needed correction in the autumn. Thus, for greater realism in budget making, a change in the fiscal year (to July or October) was suggested in India. Similar considerations have led to a change of the fiscal year to begin in July in Pakistan. Supporting these policy considerations, arguments are also advanced based on statistical convenience. Policy-oriented data, such as national income accounts, balance of payments data, and company balance sheets are largely compiled on a calendar-year basis. Change of the fiscal year to a calendar year would result in greater uniformity in statistics and would minimize distortions in policymaking. It is argued that a common fiscal year for government, for tax purposes, for companies, and for compilation of national statistics would lead to greater harmonization, better comparisons, and, therefore, to improved policymaking. Other arguments in favor of a change relate to (1) conformity with other member countries in common market zones (for example, the European Community and the former East African Community) and (2) dependence on external aid, where change to the fiscal year of the donor country leads to a better understanding of the aid commitments. For example, Papua New Guinea changed its fiscal year to January in the mid-1970s for the latter reason.

It can be argued, on the other hand, that in the continuous process of budget making, the significance of the fiscal year is at best marginal. In the context of development plans or similar expenditure forecasts, cut-off dates are primarily determined for statistical con-

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6 The United Kingdom, a member of the European Community, has a different fiscal year. Denmark and Ireland have a common fiscal year with the United Kingdom. The three members of the former East African Community have the same fiscal year.

7 Peru and Spain formerly prepared biennial budgets but now have annual budgets. Bahrain has moved to a two-year budget system from 1978. In analyzing the U.S. budget for 1973, a group from the Brookings Institution advocated a proposal for three-year authorizations and appropriations, primarily to permit more intensive but less frequent review of major programs. See Charles L. Schultze (1972), pp. 464–68.
venience and the timetable of the legislature. In the sense of planning over medium term, as in most countries, it is believed that the fiscal year per se is not important. To that extent, the relevant considerations are statistical congruence and harmonization with other systems.

Another argument reflects disillusionment with the present budgetary systems and seeks to convey the difficulties in budgeting. Because of double-digit and triple-digit inflation rates, continuous fiscal adjustments are necessary in budgetary outlays and receipts. In such a context, budgeting on an annual basis, irrespective of the cut-off period, tends to lose significance. On the other hand, budget making for short periods may have unfortunate effects. It implies that the government has no plan for fighting inflation, leading to inflationary expectations, and such a budget might give the impression that it is far from complementing any monetary measures intended to counteract inflationary upsurge.

Further, any change in the fiscal year has a disrupting effect that may confuse both the public and government officials; its benefits may be negligible and the use of a transition period prior to any change is likely to affect the continuity of statistical series.

The debate is far from conclusive. The range of arguments illustrates the complexities of a change. It is clear, however, that a common fiscal year for budgets, tax purposes, and other national statistical series would lead to a better understanding of the behavior of economic variables and to improved policy coordination. Experience of countries that have changed their fiscal year indicates that the transition has been smooth and inexpensive.

**BUDGET CALENDAR**

Budgeting and related decision making are activities that take place throughout the year but which gain momentum during specific periods. Budget making begins with the examination of every policy proposal that has financial implications and then proceeds through the more formal stages of submission in a structured form by the administrative ministries, review by central agencies, and finally, to the inclusion of draft proposals in the budget estimates, their acceptance by the Cabinet, and submission of the budget to the legislature. These stages constitute the formal elements of a budget calendar, as illustrated in Chart 3.
Chart 3. Budget Formulation: Organizational Steps

1. Preparation of budget estimate forms and instructions
2. Preparation of revenue and expenditure estimates by agencies
3. Review and consolidation of agency requests by competent ministries
4. Transmission of ministry requests to central agencies
5. Negotiations between competent ministries and central agencies. Preparation of draft budget
6. Cabinet approval of draft budget. Transmission of revisions
7. Final budget submitted to legislature for approval
The budget calendar is formulated with reference to the fiscal year, to the program of the legislature and related constraints, and to continuous expenditure planning which needs to be integrated into the main budgetary process. Reflecting these factors, different procedures are to be found in the formulation of budget calendars. In most countries, particularly the commonwealth countries, the budget calendar offers a basis not only for the new budget for the next year but also for the formulation of the revised estimates for the current year. The practices in a number of countries indicate that the formulation of the budget for the next year begins soon after the approval of the budget for the current year. In the United Kingdom and Sweden, for example, circulars for the preparation of budget estimates are sent to spending agencies soon after the beginning of the fiscal year or approximately one year ahead of the actual presentation of the budget. In the United States, the budget calendar starts about 18 months ahead of the presentation of the budget, and consideration by the Congress occurs about 11–12 months before the budget comes into effect. Similar procedures, although with less lead time, are to be found in other countries. In some commonwealth countries, such as India, the formal period of budget making is reduced to six months.

At the time when the main purpose of the budget was to ensure legislative accountability and when the economic environment was relatively stable, the budget calendar was considered a routine matter. During recent years, however, three major problems are associated with the budget calendar. First, its length is such that in some cases it could mean out-of-date estimates by the time of their transmission to the legislature. Second, the techniques adopted for submission of estimates could lead to fragmented decision making. Third, the time available for adjustment in the later stages might be too short to allow for viable policy changes.

The budget calendar is often viewed as a technical framework in which policy decisions already taken are converted into budgetary formats. On the other hand, if it is seen as an extended process in which major economic decisions are taken, then it would need a longer period. Such extended periods have, however, several practical limitations. The budget for the next year should generally take into account the financial problems during the current year and seek to introduce appropriate remedial measures by means of the following
year's budget. The identification of the span of the budget calendar with the fiscal year implies that, in practice, time is too short to take into account the problems of the current year's budget. Agencies formulate their budgets in the light of the current year's actual expenditures. If these data are not available, they budget on the basis of rough estimates, which may introduce avoidable errors. More significantly, rough estimates would require more corrective action during the year. The problem is further compounded in countries with a high inflation rate that formulate budgets in current price terms or even in expected outturn prices.

The span of the budget calendar becomes important because the longer the period ahead of the actual starting point the greater is the possibility of discrepancies arising from out-of-date figures. The discrepancies and the need for further corrective action are likely to be reduced if the budget calendar is formulated to begin some time after the start of the fiscal year in order to take into account experience in the first part of the current fiscal year. It should be recognized that reductions in spans may not always be feasible where the legislature has, as in the United States, an elaborate role in the final formulation of the budget. Moderation of the budget calendar should also be viewed in terms of the effect on the participants in the process.

Both industrial and developing countries find that revenue estimates are usually submitted only in the later stages of the process. Similarly, different dates are set for submission of current or ongoing expenditures and capital expenditures, and new proposals at various periods are treated separately by finance and planning agencies. Although such separate submissions imply some administrative convenience, they also contribute to fragmented decision making, in which the revenue constraints and the interaction between current and capital or new and continuing expenditures are not fully recognized. In such cases, the onus of finding a balance among these aspects shifts to the technique of expenditure controls and the approaches of those who exercise them. It also implies that the administrative process itself does not contribute to smooth functioning.

A major problem is also faced toward the end of the budget calendar, in that the draft budget finalized at the technical level may undergo major changes at the cabinet level. Totally revised expenditure ceilings might be indicated, requiring changes throughout the
As time is short between the draft and final budgets, the agencies find it difficult to make adjustments within the constraints of the budget calendar. The result is an ad hoc budget, so that, in the first quarter of the year another budget is likely to emerge that is far different from the approved budget and that reflects the full adjustment. This, however, leads to confusion and, more important, time that should be devoted to budget implementation must now be spent in changing the budget approved by the legislature.

**Budget Circular**

Budgeting involves the active participation of several agencies and individuals. If their efforts are to be coordinated within the time allotted, each participant must know his role as well as the roles of others. In the budgetary process, the budget circular is the vehicle for conveying the policy goals of government to the participants. Although often viewed as a routine affair, it facilitates communication before and during the entire budget process.

Ideally, the budget circular should convey the national goals, state the economic prospects of the country, and reflect the policies proposed. It has an educational role in promoting better understanding of the budget itself. The circular should indicate the resource constraints and their impact on the budget. In that light, it should cogently state the proposed increases or reductions in allocations. For example, in Japan and in several other countries, limits of expenditure growth are communicated to each department and, at a later stage, a draft budget is presented as a basis for discussion with spending departments. In Denmark, allocations for continuing expenditures are indicated on a firm basis for the next four years. In countries with medium-term expenditure forecasts or development plans, similar indications are provided. The budget circular thus summarizes these indications in more specific detail and conveys changes in the economic forecast or policies.

The circular should also indicate the methods for computing the maintenance costs of completed projects and offer detailed guidelines on ceilings for new projects. Specific attention is to be paid to the various stages of project preparation in view of the substantial time lag between initial conception of a project and its consideration for
inclusion in the budget. In developing countries, special attention is needed for projects and programs that are to be submitted to donors of aid. Indications should also be given on the price levels that are to form the basis for estimates, on adjustments for inflation, and on permissible increases in staff.

The circular has two other important functions. First, it is used as a medium for ascertaining the legal status of some policies. If legislation must be renewed or new legislation is needed, those facets come to light through the budget circular. Second, it is used for specifying the information that agencies need to submit for facilitating budgetary review.

Although the general importance of the above aspects is recognized by all governments, experience indicates that budget circulars have become routine and that they acquire notoriety for what is not covered in them. These gaps fortunately do not have any pattern and are best viewed as aberrations.

**Revenue and Expenditure Budgets: Convergence**

A related aspect concerns the submission of the expenditure budgets and revenue proposals to the legislature. In several commonwealth countries following the British tradition, expenditure budgets are presented to the legislature before revenue proposals are submitted. This practice has evolved over the years primarily in the belief that determination of expenditure is foremost in public finance because it is the basis for the revenues needed and also because revenue measures were generally well-kept secrets to prevent unseemly speculation. In retrospect, neither of these presumptions is entirely tenable. In democratic systems following the parliamentary procedures of the United Kingdom, the legislature cannot propose new expenditures or increase the proposed amounts. It can reduce expenditures, but such reductions are viewed as loss of confidence for the party in power. In such systems, expenditures are based on executive decisions and are formally approved by the legislature. The merit of the secrecy argument is also debatable, as most tax changes are anticipated by the public. However, lagged presentation of the revenue proposals has a major effect on determination of expenditures before it is known what revenues are needed for financing them. The revenue constraint may
therefore not be fully realized, and the combined effect of the budgetary operations may not be readily ascertainable.

To minimize such distortions, legislative safeguards may be introduced—for example, those in the United States. In the U.S. system, an increase in expenditures beyond the amounts set forth in the preliminary resolution by congressional committees must be accompanied by a revenue proposal for that increase. In the United Kingdom, the Armstrong Committee suggested several changes in the legislative procedure to facilitate introduction of tax measures at the same time as expenditure plans. An important concern is whether this practice would lead to greater forestalling by the public in anticipation of tax changes, but the committee felt that the formulation of tax measures would still be governed by secrecy considerations and that any adverse economic effects would be minimal. Such a practice would have the major advantage of eliciting constructive comment from the legislature on tax measures rather than forcing their passage as a fiscal fait accompli. The timing and procedures, however, depend on the legislative approach and the role of the particular legislature.

**TYPE OF EXPENDITURE CONTROLS**

Government budgets indicate the goals to be achieved with the given outlays. It is therefore essential to control the expenditure to

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8Arthur Smithies was among the many who advocated a simultaneous consideration of revenue and expenditure budgets. Instead of the fragmented approach of the congressional committees, he suggested the formation of a Joint Budget Policy Committee (see Arthur Smithies (1955)). Further suggestions on the same lines were made over the years. For a discussion of this issue prior to the introduction of revised congressional procedures in the United States, see William A. Niskanen (1973).

9The Armstrong Committee (1980) noted that advance indication of tax measures could take three forms: (1) a statement of the change in revenue considered necessary for the next year; (2) a statement of the required changes, together with alternative policy packages; or (3) a statement of the revenue change, plus a set of policy proposals. Appropriately, it considered the first as ineffective and the third as a rigid extension of the present procedures. It therefore recommended the second for comment from the legislature. (It labeled such a new budget as a “unified system.” This is distinct from the unified budget system proposed by the U.S. President’s Commission in 1968, which essentially referred to the integration of consolidated cash and administrative budgets. The Armstrong Committee’s proposal is for a unified budget of tax and expenditure plans.)
serve the avowed purposes. Expenditure controls may be positive or negative. In a narrow and technical sense, they relate to the steps in formulating the budget and to achieving both economy and efficiency. Expenditure controls essentially reflect a managerial process that is both political and administrative, dealing with horizontal and vertical relationships within government organizations. Controls, as noted earlier, relate to both the present, in that the immediate budget has to be implemented, and the future, in that the current patterns determine the future shape of the budget.

The type of expenditure controls and their effectiveness are dependent on the external and internal environment of the central agencies and the spending agencies. The types of control are determined by the attitude of the legislature and by public opinion. Although their views are not always unanimous, their expressions of concern and the broad range of interests have substantial impact on the tenor of control. The internal relationships between central and spending agencies often have greater impact than public opinion. The budget represents a central vehicle through which policies are converted into actions. In setting goals, it must be decided what is the most appropriate form through which the joint responsibility of government can be exercised. This, in turn, is dependent on the prevailing value systems, the legal process for obtaining the goals, and the participants' adherence to universal rules of authority and exercise of power. Power is both formal and informal, and often informal power is more keenly felt.

Government, to recall Pigou's remark, is not a unitary being. Its financial activity involves thousands of decision-making centers and individuals. Given the same purposes and the same resources, however, organizations have different performance ratios and achieve different results. It could be argued, for instance, that the budgetary aims of efficiency and economy are universal and therefore a common institutional framework would be desirable for the various levels of government. In practice, however, this is an impossible task because each government has its own environment, in which it functions efficiently. This is not an issue that can be treated in terms of the differences between industrial and developing countries, but it is an issue governed by administrative heritage and the interaction of that heritage with economic forces, such as the overall magnitude of
expenditures, the share of outlays directly spent by government, and the share of transfers of resources to other levels of government and to households.

The wide variations seen in the effectiveness of expenditure control can be explained in terms of the forces at work that are illustrated in Table 10. To start with, the objectives of government, which influence the approach to expenditure control, are determined at the political level. These political decisions may be influenced by the legislature or by public opinion.\(^{10}\) Within this framework, specific programs are evolved by ministries and central agencies. In the process of budget formulation, the partnership among central and spending agencies becomes vertical, the latter working within the former’s guidance. The otherwise horizontal relationship among ministries changes in view of the inherently different responsibilities of the spending agencies from those of the central ministries. The spending agencies are responsible for the policies within the limits laid down by government and are responsible for their efficiency. Central agencies, on the other hand, have main responsibility for economic and financial policies and the management of the economy. For the spending agency, the budget is an administrative tool; for the central agencies, it is a medium for allocation of resources and a tool of macroeconomic management. The central responsibility can be discharged by central agencies only through the budgets and activities of the spending agencies.

The acceptance of this crucial relationship has, over the years, initially given greater power to finance, and later to planning. It has also enabled finance to generate power and to be the recipient of power generated at other levels. The budget agency or finance ministry cannot, however, work like a military mission. The cooperation it receives and the success of its own operations are dependent on the perceptions of other agencies. To a very large extent, partial identity of

\(^{10}\)In some countries, public interest groups compile their alternative budgets for influencing public opinion. Examples of this are to be found in countries where fiscal policy and the magnitude of the government budget are highly sensitive issues. In Japan, political parries play an important role in the process of budget compilation, with the government party formulating a guideline and each opposition party publicizing its own principle. In the United Kingdom centers of learning, such as the Institute of Economic Affairs, and in the United States the Conference Board and the Brookings Institution publish special studies and alternatives to the budget strategy.
### Table 10. Expenditure Control Framework

<table>
<thead>
<tr>
<th>Control Component</th>
<th>Levels of Decision Making</th>
<th>Allocation</th>
<th>Stabilization</th>
<th>Program Management</th>
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<tr>
<td><strong>Determination of objectives</strong></td>
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<td>Functions or ministries</td>
<td>Political (Ministerial)</td>
<td>Political (executive and legislative)</td>
<td>Political (executive and legislative)</td>
<td>Administrative</td>
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<td>Program or agency</td>
<td>Ministerial/administrative</td>
<td>Political/administrative</td>
<td>Mostly administrative</td>
<td>Administrative</td>
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<tr>
<td><strong>Budgetary process</strong></td>
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<tr>
<td>Budget making</td>
<td>Political/administrative</td>
<td>Finance, planning, and spending ministries</td>
<td>Finance, planning, and spending ministries</td>
<td>Spending ministry</td>
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<tr>
<td>Budget implementation and reallocation</td>
<td>Primarily administrative</td>
<td>Administrative (finance, planning, and spending ministries)</td>
<td>Administrative (finance, planning, and spending ministries)</td>
<td>Spending ministry and its agencies</td>
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<tr>
<td>Accounting</td>
<td>Administrative</td>
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<td>Finance and spending ministries</td>
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<td><strong>Approaches</strong></td>
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<tr>
<td>Political level</td>
<td>Partial identity of interests</td>
<td>Differential interests</td>
<td>Identity of interests</td>
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<tr>
<td>Administrative level</td>
<td>Central/fragmented</td>
<td>Partial identity of interests</td>
<td>Differential interests</td>
<td>Identity of interests</td>
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<td>Problem areas</td>
<td>Inert areas</td>
<td>Cost reductions</td>
<td>Quality of services</td>
<td>Control trends</td>
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<td>Political/administrative</td>
<td>Differential approaches</td>
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<td>Administrative</td>
<td>Mostly differential approaches</td>
<td>Mostly differential approaches</td>
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<tr>
<td>Control trends</td>
<td>Normal</td>
<td>Decentralized approaches</td>
<td>Decentralized approaches</td>
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<td>Centralization</td>
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<td>Crisis periods</td>
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interests occurs in the allocation stage at the political and administrative levels, while in the context of stabilization it is likely that differential interests will emerge among central and spending agencies because of different perceptions on what expenditures can and should be reduced. Similar issues arise in the vertical relationships within spending ministries and their agencies. Differences in perception and advocacy arise, both horizontally and vertically, in the identification of inert areas. More often than not, spending agencies attach greater importance to their programs, which may not have the same priority on a national scale. But once areas of obvious waste and ways in which they can be remedied are established, ministries and spending agencies will have greater identity of interests. Objective criteria for determination lead to better control. When output measures and cost indices are available, control is objective and becomes less biased. Traditional factors may influence the central agencies to pay less attention to the quality of services in their zeal to achieve cost reductions, while spending agencies, being closer to their clientele, are likely to emphasize quality. The possibility of conflict therefore is as great as the entire budgetary process.

Such conflicts are sought to be resolved in different ways in different systems. In the United States, there is considerable decentralization of power to spending agencies, which have complete operational freedom within approved budgets. In continental Europe, too, spending agencies have a great deal of independence. In the French system, spending agencies have greater responsibilities for policy formulation than for financial and accounting controls, which are traditionally handled by the officials of the Finance Ministry. In Italy and Latin America, the general accounting offices similarly exercise financial and accounting controls. In the United Kingdom and in commonwealth countries, accounting controls are largely exercised by the personnel of the Finance Ministry, while policy and financial controls are assigned to spending agencies. Following the reforms in the United Kingdom in 1927, the principle that administrative policy formulation, on the one hand, and financial management and program implementation, on the other, should be integrated has gained greater acceptance. It was recognized that separation of these two functions could adversely affect financial management and might imply policy formulation without the necessary resource constraints. Administrative and financial
responsibilities belong together. In some commonwealth countries, notably in India, the gradual devolution of financial responsibility was achieved by financial advisers. In the early 1950s, advisers were provided by the Finance Ministry to major spending agencies and the system was later extended to all ministries. Financial advisers, who initially served both finance ministries and spending agencies, were subsequently expected to serve only the latter. \(^{11}\)

An analysis of the relationship between finance ministries and spending agencies reveals a cyclical pattern and a three-stage development. First, in the early years, when a government was small and its tasks were more manageable, finances were centrally controlled by royalty or their trusted representatives (as is still done in some Emirates in the Middle East). Second, with the growth of government, there was gradual decentralization of authority to spending agencies, subject to the observance of specified general principles. Such decentralization suited the managerial requirements and facilitated implementation. In some countries, the pace of decentralization was quickened by the emergence of coalition politics. Third, centripetal forces emerged again later, largely reflecting the requirements of a coherent economic management program. Administration of finely tuned economic management policies demanded a greater degree of centralization. Periodic economic crises strengthened this trend and, in some industrial countries, compensating measures were taken to strengthen financial management systems. For example, in Finland, financial controllers were appointed in spending agencies to investigate possible economies. In Canada, an Office of Comptroller General was set up for the entire Government. In the United States, drawing on European practices, Inspector Generals of Finance were appointed selectively in spending departments. In developing countries, particularly those at an initial stage of administrative development, the shortage of trained manpower contributed indirectly to a strengthening of the inherited centralized framework.

The significant issues pertaining to existing expenditure controls may be examined with reference to the relevance of control by direction, control by inducement or through a system of incentives, \(^{11}\)

\(^{11}\)For a detailed review of these aspects, see A. Premchand (1966b).
control by concertation, and the appropriate mix of policy and machinery. Control by direction implies that there is a strong central agency that is responsible for the economic management of the country and that it will provide direction to the numerous decision-making centers regarding their responsibilities. Such control also implies considerable centralization, and it is often suggested that central direction permits a coherent view of government policies, as well as facilitating decision making and implementation. The smooth functioning of control by direction requires a capable staff that can provide direction to the different areas of government. From the point of view of budgetary policy, data on the relation between input and output and costs should be available to enable the directing agency to give precise directions. In practice, however, central direction proved to be difficult and, as noted earlier, decentralization came to be adopted. Centralization stretched the limits of organization and became disfunctional. Furthermore, such control often became illusory because the lines of communication were not clear and because in reality action differed considerably from intent. As budgetary systems had not developed sufficient data on input and output relations and costs, central agencies came to be content with the specification of acceptable behavior in the spending agencies—in practice, setting accounting controls. Excessive dependence on central agencies contributed to a lack of effort in spending agencies and to making the Finance Ministry a whipping boy for all omissions and problems in government policies.

To mitigate the problems of centralization, three major approaches have been suggested in recent years. Broadly, these advocate a reduced role for the Ministry of Finance—each for its own reasons. One suggestion is that the functions of the Finance Ministry should be limited to the formulation of policies and that implementation should be left to the spending agencies. Another suggestion is that the objectives of government should be stated clearly and periodically, while yet another suggestion is that the role of central agencies should be confined to prebudget scrutiny. The first and the third suggestions

12 In a sense, such a central agency is similar to the unitary form of firm in which complete direction is provided. Firms are classified, for purposes of control, into unitary, holding company, multidivisional, transitional, and other forms. See O. E. Williamson (1975), pp. 151-54. Decentralization in government is comparable with controls in a multidivisional firm.
reflect variations of a theme. The second suggestion is carried out through medium-term development plans or financial forecasts and has been implemented in several countries in varying degrees. Decentralization of this type can be successful only when the spending agencies are fully capable of meeting their budgetary tasks. In practice, this was found to be a key handicap because spending agencies were more eager to pursue their policies than their finances. Partly this was due to the halfhearted implementation of decentralization itself. Moreover, spending agencies continued to rely on the Finance Ministry as a convenient feature of “redundance” or a backup system. In the United States, where decentralization was systemic, it developed a reverse dependence, in that the central agencies had to depend on the spending departments. If nondelegation of financial powers swamp the central agencies with an enormous workload and a range of issues that may stretch their analytic capabilities and effectively contribute to lack of financial management within spending units, it appears that liberal decentralization is not without problems either, for it reduces the capabilities of central agencies in carrying out their tasks. While the tasks of the central agencies have been helped by the introduction of information systems, problems still persist in both lines of approach.

Recognition of the drawbacks of control by direction has led to the advancement of control by incentives. It should be noted that this is largely a theoretical framework, as yet not fully refined. Schultze, who did much earlier work in this area, recognizes that the success of a majority of the programs is dependent on the response of the different decision makers in government, as well as on the extent to which the program benefits accrue to the intended beneficiaries—namely, the community. Therefore, Schultze suggests that incentives be included in the program design and in the formulation of budget itself. For example, irrigation programs of government can have appropriate tax and subsidy strategies to induce farmers to utilize the benefits. Similarly, certain average costs of services can be specified and agencies that keep within these costs can be rewarded. Schultze does not suggest that the whole range of government programs should be redrawn along these lines. Control by incentives, he believed, was to be applied selectively to supplement the traditional expenditure controls.

The introduction of incentives in government would require the specification of output, costs, and measures of performance—all areas in which little real progress has been made. There are two other limitations to this approach. First, it changes financial control from a bureaucratic technique to a broad philosophy that tends to change the character of public programs. In due course, it is likely to have an impact on the very nature and functions of the state. Second, provision of incentives to government employees outside their normal career opportunities is difficult. Such incentives do exist, ironically in centrally planned economies of the East European type. Notwithstanding these limitations, the selective application of this approach is worthy of further exploration.

Like the above controls, control by concertation has only been applied in a few situations. Basically, it recognizes that central controls have grave implications, while a decentralized system is not fully compatible with the central responsibilities of finance and planning agencies. Control by concertation views the relationship between finance and spending agencies as one of joint efforts in a common enterprise or a mutually compatible framework. The Plowden report in the United Kingdom\textsuperscript{14} pleaded for a “right balance and differentiation of function” in the unique relationship between these two types of agencies. Control by concertation emphasizes mutual consultation between the Finance Ministry and other agencies as an essential base for the formulation of policies and the functioning of controls, contributing to greater realism in central policies and to more effectiveness in the agencies. Practical experience with this technique, however, appears to have been limited to periods of financial crisis and its application during normal times is yet to be undertaken.

In the exercise of expenditure controls, the balance between policy measures and control techniques is important. In most programs, the role of the latter is peripheral and much depends on the policy premises. For example, absence of restrictions on subsidies, or less specific policies for entitlement payments, can hardly be expected to be compensated for by stringent controls. In fact, excessive reliance on control mechanics and their use in compensating for policy shortcomings could overload the machinery and build up undue expectations on

their efficacy—and, when the realities are known, lead to frustration and to a general condemnation of controls. In such an atmosphere, public attitudes become even more critical, and a pervasive feeling might develop that outlays are uncontrollable. Financial discipline would be the first victim of such approaches. Pragmatic approaches to control should therefore seek realistic delineation of the role of policy measures, the role of controls and techniques, and their mutual complementarity.

SELECTED ISSUES

The working of the budgetary organizations discussed above reveal several problem areas that merit more detailed consideration. Some of these are considered below.

Policy control

In an ideal world, where all forces are at equilibrium and all individuals (and, by extension, organizations) work according to rationality models, there would hardly be a need for a Finance Ministry or a central controlling institution. The conflicts that normally arise would be settled by the working of the invisible hand. If all techniques, approaches, and procedures were applied as intended, the result would be a smoothly functioning system. The day-to-day world, however, is different from such expectations. Current discussions suggest a growing feeling of uneasiness about the growth of public expenditures and about the apparent inability of governments to cope with fiscal problems. It is alleged that policy controls of government have failed.

The forces contributing to this situation can be analyzed in terms of political, administrative, or financial controls. From a political point of view, decisions concerning finance are taken outside of the budget and the Cabinet. The Finance Ministry is not consulted before the Cabinet considers proposals for expenditures. Furthermore, the Cabinet itself is usually a divided body, with divergent views on spending and saving. It is even suggested that the ideal pattern of cabinet government is a rarity. While some issues relating to budget controls should be dealt with at a political level, the Cabinet must have
a coherent view of the role of the budget. This implies that, even where the budget is organized to reflect only segments of the government, supplementary procedures would be needed to bring together the totality of public expenditure.

In several countries the Cabinet is subdivided into committees to facilitate the consideration of financial matters, but a major limitation in their functioning has been the lack of explicit recognition of financial and economic constraints. As a possible corrective, the Canadian Government has recently introduced an innovation, under which the Cabinet is divided into nine policy sectors (so-called envelopes), each being responsible for management within the resource constraints indicated for those sectors in the multiyear fiscal framework. As experience of this type is limited, no assessment can yet be made. However, it signifies the involvement of the Cabinet in matters of detail and its determination to keep the budget within recognized ceilings. While more experience, specifically during periods of financial stress, may reveal shortcomings, the potential of this approach cannot be overemphasized. Similar efforts, although less impressive, are being made elsewhere and only the future will tell whether they have been successful.

The smooth functioning of policy controls is impeded by the administrative approaches adopted by spending agencies in the budgetary process and in all financial matters. It is frequently alleged that spending agencies do not furnish the requisite information about their proposals. For several new policies, the financial implications may not yet have been fully worked out, but the policies, owing to time pressures, may still be introduced. It is also observed that spending agencies often do not furnish information even when it is available, lest it might adversely affect the outcome. As a result, costs of projects that have initially gained budget support on the basis of underestimation have subsequently ballooned. This phenomenon, which is termed as the “camel’s nose” or “tip-of-the-iceberg” approach to budgeting obviously has an undesirable impact on policy formulation. It is debatable, however, whether this approach is adopted deliberately or unwittingly because more detailed information is not

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15 In the United States, congressional committees have repeatedly pointed out that if full information had been made available, decisions would have been different.
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available. The experiences of countries vary in this respect, and a number of cases may be cited to prove both contentions. If information is available, why cannot departments be requested to furnish it? Hartle believes that the government as a whole has “bigger fish to fry” and would not like to engage in arguments over nebulous issues.\(^\text{16}\) While this attitude may not necessarily be universal, it once again underlines the basic relationship between central and spending agencies and the need for concertation. At a practical level, spending and central agencies are often concerned only with the budgeted costs and not with the unbudgeted costs. Given the organizational structure of governments, provision for land and buildings for one department may be made in another department’s budget as is true for pensions and many other benefits. The lack of appropriate market prices for some services of government adds further complexity, so that costs included in the departmental budget might often be understated, possibly leading to overuse and overexpansion of activities.

The purposes of policy control would not also appear to have been adequately served by the approaches to control. The review by the central agencies, it is argued with some vehemence, is often tantamount to “nibbling at the fringe,” the approach to control is tactical rather than strategic, intuitive rather than objective, short term in its orientation, and narrow in its focus. Control, which should be predictable, becomes arbitrary and ad hoc. The central agencies for their part would argue that the spending agencies have not been cooperative and have paid little attention to the financial aspects of policies. While arguments on both sides have merit, it is clear that overall control should be concerned not only with a program in itself but with its linkages with other programs, not only with annual changes but with the placement of those changes in government priorities, and not only with immediate visible costs but with indirect costs as well. These points are self-evident but their beneficial influence would be felt when they are ingrained into the budgetary process. It could be argued that in strengthening the budgetary process policy control is only a minor aspect and that, if controls are to become viable, political determination is more important. The debate, however, is not over whether political or administrative control is

\(^{16}\text{Douglas G. Hartle (1978), p. 46.}\)
better; the two are complementary. Some budget analysts argue that budgetary systems are sufficiently well developed and that the tasks of control can be better met only when there is an ability to manage them in a political sense. Others hold the view that budgetary systems are still far from ensuring that the resources deployed in the budget obtain the maximum effect. Budgetary systems, both at political and administrative levels, have no real finality in their development, and their effectiveness depends on their responsiveness to changing requirements.

**Earmarking of funds**

The growth in the earmarking of budgetary revenues for specified purposes has been noted earlier. Arguments have been advanced over the period for greater earmarking, as well as for minimal earmarking or none at all. As with other issues of public policy, these arguments mix reason and emotion, the latter tending to obscure the realities. The choice of the extent of earmarking must be made, if at all, after a pragmatic consideration of the nature of earmarking, its spread, its strengths, and its weaknesses.

Earmarking is of two types—a specific allocation of a percentage of revenues or a specific amount allotted to special funds. Earmarking is done both by constitutional provisions and by specific legislation. It is substantial in Latin American countries and is found in Japan, Korea, the Philippines, and Thailand in the form of special accounts. However, it is rather moderate in the French type of budgetary system and is even less in the British type of system.

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17The Danish Government has, for example, felt that “the budget and planning cooperation between central and local governments is today so well organized and the systems of information are so well developed that both management and control can take place in a reasonable way. . . . What—in the perspective of history—can be doubted is the ability to manage, in a political sense, the structural adjustment that is necessary” now? (Budgeredegeørelse [Multi-Year Budget White Paper], Copenhagen, 1980). The Swedish Budget 1980/81 (Stockholm, 1980, p. 57) views the issue as a technical one and believes that “the question to consider in the current perspective for fiscal policy was how the resources that are already being channelled via the Budget can be deployed to maximum effect.” The points of view have undoubtedly been influenced by the respective policy and institutional settings.

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The basis for earmarking can be a broad one. For example, the Islamic Republic of Iran traditionally earmarked its oil revenues for the development budget. In some cases, the basis can be very narrow and specific. Typical examples are cesses and agricultural betterment levies for the development of crops or gasoline taxation for the financing of highway construction. In Peru, part of the proceeds of import taxation were similarly earmarked for financing defense imports. Variations on this theme are found in every country.

The enthusiastic supporters of earmarking point to the advantages, especially its philosophical basis and its inherent managerial facility. It is suggested that earmarking provides a direct link between costs and benefits of taxation and a strong case for additional taxation. From a legislative point of view, it provides greater accountability and is convenient to the decision maker because it reduces the political inefficiency inherent in resource allocation. In many Latin American countries and elsewhere, however, earmarking has emerged as an escape-mechanism from legislative purview. Confronted by legislative antagonism and prolonged delays in approval of the budget, the authorities chose earmarking as a method of reducing legislative intervention and control over annual budget making. At a managerial level, earmarking is expected to gain greater efficiency because autonomous functioning of the budget is likely to contribute, with appropriate incentives, to minimization of costs and maximization of services. Further, earmarking reduces uncertainty in annual budget allocations and permits those responsible to plan ahead and to implement the budget.

In reality, each of those aspects appear to have led to greater problems rather than to solutions. The link between the payment of taxes and the benefits to the taxpayer has often been difficult, and game considerations may have contributed to taxpayers pretending that they have less concern for the proposed public goods than they, in fact, have. The remoteness of benefits and the lack of complete knowledge about the budget allocations has aggravated the feeling. Administratively, the growth of earmarking lent credibility to the view that the government had no real budget and that legislative controls were declining. The prevalence of earmarked funds contributed to the promotion of enclave mentality in those responsible for administering of such funds; when flush with funds, administrators
engaged in overinvestment in their spheres of activities. In New Zealand, for example, the use of gasoline taxation for highways led to such a situation, and efforts were made in the early 1970s to reduce earmarked funds. Earmarking implied a rigidity: while some functions had more funds than needed, a few were starved of funds. National priorities were adversely affected. In tight fiscal situations retraction of allocations made to earmarked funds proved difficult. As an extension of this, the pursuit of anti-inflationary policies became a formidable task. As the prevalence of earmarking contributed to a slackening of central controls, agencies financed by earmarked funds tended to become a law unto themselves, contributing to a needless complexity of the budget.

These experiences should not, however, be considered a general rule but as instances where the effectiveness of earmarked funds was thwarted. Like any other technique, earmarking has its uses and abuses. Its usefulness is directly dependent on the spread of the earmarked funds, the flexibility in their management, and their relationship to the budget and national priorities. Whether earmarking is a lesser evil or not should be considered from these two aspects.

**Personnel budget**

One of the main functions of the traditional Treasury or Finance Ministry is control over the personnel aspects of government so as to ensure economy in employment and parity and uniformity in government pay. Both these aspects have received increasing attention for several reasons. The public sector is the major labor-intensive industry in any country and the number of government workers has grown during recent years. In the industrial world, the extension of welfare services and, in some cases, the modernization of defense forces has brought about such a sharp increase in public services that now more than 20 percent of the labor force is employed by government. In developing countries, the implementation of development projects, the expansion of the armed forces, and the adoption of policies under which the state is obliged to provide employment to school leavers or graduates have contributed to a rapid expansion of government personnel. As numbers of such workers grew and as greater portions of government budgets came to be spent on wages and salaries, attention
focused on problems encountered in formulating personnel budgets. The growth in numbers has also tended to confirm the traditional view that services provided by government tend to be costlier because of their labor-intensive nature. But the growth has also stimulated the feeling that employment as a goal in itself, unrelated to organizational requirements, contributed to considerable “slack” and to greater x-inefficiency. Simultaneously, the growth in numbers and the growth in civil service unions brought about new realities in budget making. In some countries, where civil service is represented by strong and militant trade unions, the role and decision making of central agencies have undergone considerable changes. These changes and related problems may be analyzed in terms of (a) the creation of additional posts, (b) the reduction in the number of posts, and (c) the government pay structure.

Creation of additional posts is a complex process that is generally expected to be completed before the beginning of the budget calendar. In theory, the staff requirements of each agency are expected to be reviewed and established with reference to work-load factors, which also determine the job classification pattern of each agency. The staff requirements are then reviewed during the formulation of the annual budget, and changes are determined with reference to new programs and projects. As an integral part of this process, appropriate changes are also made in job classifications to reflect growing work loads or staff mobility requirements. The budgetary process also requires that ceilings on the growth of personnel be indicated as part of the resource ceilings communicated to spending agencies. Any targets specified for staff reduction must be indicated to the agencies, so that they can be reflected in their budgets. The smooth functioning of the process is, therefore, contingent on (1) the availability of criteria for the determination of staff strengths and (2) suitable indications to spending agencies on permissible rates of growth well ahead of the annual budget exercise. In practice, however, there are many problems.

18Control of personnel by the Treasury has been an old problem. The traditional concerns of the Treasury have been growth in numbers of workers, problems in the determination of posts, monitoring of actual trends, and attempts at reducing the number of posts during periods of financial strain. For a historical discussion of this aspect in the United Kingdom, see Maurice Wright (1969).
First, with the gradual movement away from the object categories of expenditure to programs and objectives, it was expected that emphasis on personnel growth would yield to emphasis on controls over programs, and it was expected that personnel management would be an integral part of program management. The substantial growth in numbers has, however, contributed to a change in philosophy and in the controls over personnel, which were reintroduced even in countries that implemented program budgeting (for example, the United States). In effect, this meant that, regardless of the budgetary system and its degree of modernization, controls would be exercised over both programs and personnel, implying that work-load data would be fully related to personnel requirements.

This, however, has not been true in practice. For one reason, the objective criteria and measures for creation of posts have not been fully developed in a number of countries, although several countries have made noticeable progress. Improvements include the establishment of manpower units in agencies and formulation of standards in the productive, service, and administrative sectors of government. The formulation of standards and their constant revision to keep them up to date are, however, both formidable tasks in any organization. Where such standards exist, controls appear to have been exercised more for restraining future growth than for achieving reductions in staff. In fact, indication of man-year controls and related criteria might have had a perverse impact on spending agencies that persistently managed to show staff shortages relative to the work done by them. Agencies were reluctant to undergo central evaluation of their work, lest this might reveal where staff reductions could be made and could thus lead to reduced allocations.

In some countries, notably in the United States, restrictions on staff growth appear to have been circumvented by the appointment of consultants. This tendency has, over the years, led to a situation where government functions are carried out by consultants who are not a part of government. The growth of this borderline activity has been substantial.

In a number of countries, an organizational dualism has developed where the creation of posts is done by the Civil Service Commission, the Public Service Board, and the Establishment Board, while funding is provided by the Finance Ministry. This division of duties, which is
fairly common in both industrial and developing countries, has led to several practical problems. The separation implies that creation of posts will take place without resource constraint and that, once posts are created, either more resources will be provided or the posts reduced. As budget reviews take place at different times, confusion between the creation of posts and their funding is to be expected. When reduced financial allocations are made, spending agencies find it difficult to make adjustments and, to alleviate the problem, resort to overestimating their demands. Both the budgetary process and financial discipline are natural victims of this confusion.

Associated with the above and in connection with economies in expenditure, reductions in public employment and restraints in the growth of government pay have become more important. One reason for such importance is that, if personnel can be reduced or their increase restrained and if restraint or freeze is imposed on the pay structure, the need for economies in specific sectors can be obviated. This approach, however, may have the effect of leading to higher government outlays in the immediate short run. In industrial countries, reduction in employment is accompanied by compensatory payments through social security systems, and the transfer of personnel from the government payroll to the welfare rolls may have a longer-term impact on government. As the abrupt termination of services is difficult, redundancy in government can be achieved only through attrition and by short-term and medium-term measures. In the United States and several developing countries, greater reliance is placed on an across-the-board freeze on creation of posts and selective reduction either of posts whose occupants have retired or of posts that have been vacant for some time. In New Zealand a variant of this scheme (known as the “sinking lid”) was introduced, under which departments were directed to eliminate annually $1.5$ percent of their staff. However, as tasks and services remained the same, departments resorted to greater use of capital and expenditures continued to grow at previous rates. Short-term measures without changes in the underlying policy cannot be expected to yield dramatic or durable results. In Japan, however, a medium-term plan comprising administrative reforms and personnel retrenchment has been initiated. It appears that planned attrition, undertaken jointly with medium-term expenditure planning, is likely to prove more beneficial than short-term measures.
The main issue in personnel budgeting is the role to be assigned to the Finance Ministry. Since institutional dualism has contributed to avoidable problems, the solution may be to bring the institutions together and arrange for their integrated functioning. Integration of personnel with finance would permit a coherent policy for the creation of posts and their funding. However, this approach has several limitations. Integration implies that the budget agency has a managerial function that most budget agencies are not equipped to perform. It can also lead to extreme centralization, with which the agency may find it difficult to cope, and the cure may prove worse than the disease.\(^1\) A preferred alternative is to retain the institutions but arrange for coordination of functions. The central themes of financial control and personnel planning should be coordinated, and greater opportunities need to be accorded to the finance agency in the budgetary process.

A similar central responsibility is needed in regard to the formulation of pay structure for government employees. This responsibility is traditionally a part of the Treasury's work, because decentralization would lead to chaos in the absence of parity between rates paid and kinds of work. But, by and large, this area is a neglected one. During recent years frequent adjustment for inflation, introduction of incentive awards, prevalence of too many grades, and the normal rate of grade or salary creep that adds to expenditure have led to increasingly greater discussion on the issue of determination of pay and its revision in governments.

Two preliminary considerations need to be noted. Government employees include military, civil, and industrial personnel. The civil service, in turn, comprises an enormous variety of workers, including administrators, teachers, engineers, doctors, and nurses. The complex varieties of work necessitate complex pay structures that aim at achieving parity. Government outlays consist of wages and salaries, and the concern here is with the latter. Wages are defined as remuneration for temporary and specific services, while salaries are

\(^1\) The Lambert Commission Report recommended, the inclusion of staffing and training functions in the Canadian Treasury, to be named the Management Board. The Public Service Commission's role would be restricted, in its view, to see that recruitment is done on a sound basis (Canada, Report of the Royal Commission on Financial Management and Accountability, 1979).
defined as remuneration for longer-term employment that entails other benefits, such as pensions and perquisites. The determination of salaries may often be undertaken as part of the package of total benefits, while wage revision may not involve any benefits other than the wage itself.

The general principles of price determination—supply and demand—are not entirely applicable to the pay structure of the civil service. Although supply factors do have some implications, the major economic factors are the government's capacity to pay, the parity principles within government services, and, to a lesser extent, the opportunity cost of attracting personnel. In the early part of the twentieth century, the Royal Commission on the Civil Service in the United Kingdom enunciated as the primary principle of civil service that pay “should be fair comparison with current remuneration of outside staff employed on broadly comparable work, taking into account other conditions of service.” While the principle itself is unexceptional, two factors appear to have contributed to a moderate pay structure. One was the decisive approach to avoid the creation of social elites by high remuneration. Although, during periods of colonial administration, such an elite class was the avowed aim of the metropolitan government, subsequent emphasis on egalitarianism and the salary structure of the political class itself acted as dampers. Another factor was the capacity to pay. In most countries, there are differentials in pay for employees of central, state, and local governments although they might be working in the same city. While cost of living raises and similar compensations are offered on a uniform scale, the basic pay itself is different, partly because of differences in responsibilities and partly because of different fiscal capacities of the employer. In cities where the private sector is dominant, governments have to compete to attract talent, but in reality their pay structure cannot compete with that of the private sector because their capacity to pay is limited.\(^{20}\)

However, the government structure cannot remain static. It needs frequent revision to assure continuation of the standard of life that

\(^{20}\)In some countries, civil service within government may not have a uniform pay structure. For example, in Indonesia, employees of a few departments receive more pay because of their greater involvement with the public and the fear that, unless they are suitably compensated, they might be easily corrupted.
formed the basis for the original pay structure. Such revisions have to be made within a given framework. First, any revision must be compatible with other national objectives, particularly growth of the economy, distributional concerns, and likely impact on the rate of inflation. Second, following this precept, it should be a part of national wage policy. Third, in keeping with the objective of containing inflation, it must ensure that the increase in the total wage bill is not more than the expected increase in the productivity of the public sector. Within this framework, consideration must be given to the ability to pay and the need for having wage structures that are comprehensive and easy to administer. The revision must also have a degree of solidity about it, as too frequent revision or a revision limited to a specific sector will only bring demands for further revision.

Two other issues in personnel budgeting may be noted. Industrial and developing countries have found that decisions on pay matters are mostly the result of inquiries by ad hoc bodies and are not institutionalized within the government. Pay research units are rarities and their absence may have contributed, in part, to the growth of personnel problems. Also, pay revision is either too frequent and outside government control or too infrequent, resulting in a need to raise the pay level considerably at one time. Any pay revision incorporating such a precipitate rise will also lead to a substantial jump in the wage bill and to cutbacks in other areas if expenditures are to be maintained at projected levels.

**Regulatory budget**

An important fiscal policy issue relates to government regulations—difficulties in conforming to them, the costs involved, and their likely disincentive effects on industries. The government budget must take into account the revenue-raising and expenditure-incurring aspects of regulation. Revenues may be raised by assessing penalties for violations or they may be lowered when tax incentives and other concessions are provided. Expenditures may involve direct transfers of capital, subsidies, and implicit subsidies inherent in lower interest rates. In view of the growth of these tax concessions and expenditures, it is suggested that tax expenditures should be quantified and presented to the legislature. Such quantification of tax expenditures involves a
systematic identification of tax relief and allowances with related items of public expenditures. The implicit belief in this approach is that elements of tax expenditures and direct expenditures are largely interchangeable and that consideration of both in the budgetary process would help to formulate economic policies designed to revitalize industry. More recently, the possibility has been explored of formulating a "regulatory budget" showing the impact of proposed regulations, benefits likely to accrue, and costs to government and to industry. Measurement of regulatory costs and benefits is, however, difficult and is further compounded by the lack of an accepted accounting basis. Moreover, some regulations may be issued by autonomous agencies whose budgets are not included in the government budget.

There has been limited success in preparing tax expenditure and regulatory budgets. In the United States an estimate of tax expenditures is included in the budget, while in the Federal Republic of Germany a report on subsidies accompanies the budget every other year. Such additional information, while not having a decisive impact on policymaking, permits a regular review and prevents the assumption that the benefits are permanent or normal. As expenditures of this type increase, it is likely that tax expenditure and regulatory budgets will be needed and that more attention will be paid to their formulation.

Public works budgeting

Government outlays on public works—comprising construction activity mainly on roads and bridges, airfields, drainage and sewerage systems, docks, harbors and canals, inland and sea defense works, multipurpose river valley projects, public housing, office buildings for government activities, and structural work connected with electricity systems and telecommunications—have greatly increased during the past three decades. Construction is a major visible index of government effort and development and its involvement in this major area consists

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21 The term budget is viewed by some as a misnomer, for what is essentially sought is an application of cost-benefit techniques to regulations. Similarly, tax expenditures are also considered as a device for classifying tax concessions in terms of expenditure categories.
of (1) direct construction undertaken by its own staff; (2) contracting of specified projects to the private sector while retaining responsibilities for design and supervision, as well as the early phase of commissioning; and (3) more recently, overseeing the ecological impact of construction in both the public and private sectors. Construction is also an area where governments have built up enormous inventories of heavy assets involving substantial outlays and where a large number of people are employed. A great deal of work is contracted out to the private sector, which has firms offering specialized services, such as designs for nuclear power systems, and vertically integrated firms owning quarries and workshops, mechanized plant, and standard building equipment. Governments have specialized agencies such as the Property Services Agency in the United Kingdom, the Army Corps of Engineers and Bureau of Reclamation in the United States, and the Public Works Departments in commonwealth governments, with total responsibility for construction of one kind or another.

Reflecting the crucial role of public works and being constantly in the public eye, contract performance and management, in particular the financial aspects, have come to receive a steady stream of criticism in the media, although construction contracts have been neglected in the literature on budgeting. These criticisms cover both the financing and the management of contracts. From a financial point of view, it is stated (on the basis of empirical evidence) that costs of public works tend to escalate, that the final cost of the project is often a multiple of the original estimate, that schedule slippages are too many, and that projects are completed too long after the envisaged date. The gaps between expenditure plans and realities for government construction are too wide and outlays do not fully reflect the quality of works completed, leading to the feeling that there is an expenditure illusion. Some outlays are considered economically unproductive, and some projects have more visibility and prestige than priority and

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22 For example, in the United Kingdom, about 20 percent of the workers engaged in construction are employed by public authorities at various levels (United Kingdom, Britain 1977: An Official Handbook (1977), pp. 49-52).

23 Contracts have been generally considered as a part of general project management and not as a separate sector. Some pilot studies on performance budgeting have, however, paid attention to the application of these techniques to public works. See S. S. Viswanathan and A. V. Chaturvedi (1972).
financial viability. From a management point of view, it is noted that maintenance of government buildings and other works is poor and expensive, and the whole area of contracts is perceived as one that seethes with corruption at all levels in government.

The above criticisms are not exhaustive but are cited here to illustrate the nature of the problems involved. Some of the criticisms are applicable to financial management systems as a whole, but they have even greater relevance to public works budgeting. The experiences of a number of developing countries reveal that very few government agencies have in-house facilities for designing works or, when construction is performed by outside consultants, for reviewing the cost estimates indicated in the feasibility study. In order to obtain approval in the initial stages, estimates appear to be pegged low and then revised upward during the construction stage. Apart from inflation and the triggering of escalation clauses in contracts, final expenditures turn out to be more because of frequent changes in designs and additions after work is commenced. Administrators tend to retain control of a project by keeping its requirements incompletely defined and subject to change. Many contractors prefer to cooperate with them, as loose arrangements present less business risk and probably more work. There is also the problem of implementation being held up for shortage of funds or slowed down as a result of natural calamities, monsoon ravages, and physical shortages. Many developing countries do not have the financial capability to maintain "redundant" supplies of equipment as a reserve, and any breakdown will lead to prolonged delays in the completion of the work. Unproductive investments are made and wrong technologies are chosen, partly because of lack of investment planning and partly because of politicization of the budget-making process. Cost benefit analysis, which has a great applicability for the public works programs (its origins were primarily in the area of multipurpose river valley projects), is not extensively applied. Because public works are highly visible and tangible, political representatives frequently add their favorite projects to those proposed by government. In the United States and the Philippines (prior to 1972), experience conclusively indicates that "pork barrel" considerations lead to bloated public works budgets that are spread over a number of years and that some queuing is arranged to reflect political interests. Even in administrative systems oriented to the cabinet form of governments, public works budgets...
receive considerable attention in the Cabinet and additions are often made. Australia in the early 1930s and Papua New Guinea since its independence have found that projects are added by the Cabinet and that works programs are revised. When such considerations dominate, hasty judgments on projects are inevitable.

Management considerations are also important. Reflecting the dualism in policy approaches, more emphasis appears to be placed on the construction of new public works than on their maintenance. Maintenance is viewed as less capable of generating income or is the casualty of austerity measures. Another management consideration that dominates discussion of public works relates to the award of contracts. Contracting is viewed in different ways, depending on the viewer's vantage point. In the developing world, particularly in countries that are dependent on imported technology and manpower, officials see the process of contracting as a complex one in which private contractors have the upper hand. Budgetary estimates of costs are considered by bidders as the floor rather than the ceiling, and contracts are often rigged, revealing informal cartel arrangements among bidders. The bidders, however, argue that payoffs are common and that contracts are awarded without adequate regard for technical quality, schedule and price, and the experience of the contractor. All these arguments have some validity. While the practices described are not universal, they are not infrequent. Some contracting problems can only be remedied by attempting reforms in the overall field of public administration, while others can be mitigated by strengthening the budgeting of public works.

In regard to strengthening the budgetary process, a preliminary consideration relates to the option between use of in-house facilities and outside contractors. Construction is an area where the private sector has a great deal of expertise and experience. Establishment of in-house facilities implies direct employment of workers and frequently direct construction. The budgetary system envisaged is dependent on the choice made. Reliance on outside contracts implies a budgetary process with a pronounced accent on the review of contracts. Building up of in-house facilities implies a budgetary process geared for direct

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24 The picture is by no means uniform. In the United Kingdom, 41 percent of the workers employed by government in 1977 were occupied in building maintenance (United Kingdom, Britain 1977: An Official Handbook, 1977).
construction and private contracts. Whatever the choice, the budgetary process may need to be strengthened if the criticisms mentioned earlier are to be minimized. The first choice involves a further choice—between renting accommodation or building anew. These conscious choices have a direct influence on the extent of contracting to the private sector and whether such contracting is more economical than direct involvement.

Special considerations

Budgeting for public works has several components and the approaches to these vary. With regard to maintenance, budgeting concerns relate to its periodicity and its impact on the longevity of the buildings or structures. These concerns translate, in practice, to the outlays that are included in the current budget and those that are included in the capital budget. Approaches to the current budget tend to emphasize the element of continuing outlays, while approaches to the capital budget stress the total cost of the project and the annual profile of expenditure. Both types of outlay involve long periods from design to completion of the public works and therefore need medium-term advance planning. Formulation of these budgets requires advance consultation with spending agencies and an indication of resource ceilings. Consultations with other levels of government are also needed, as construction activities of regional, state, and local governments are frequently financed by conditional transfers from central governments.

The budgetary process should also resolve issues as to how and when to fund projects. In funding the projects, the major issue is whether the approved funds should be made available on an obligation basis to project authorities. Supporters of managerial autonomy believe that a firm indication of funds and their availability to project authorities reduces uncertainty, prevents resort to alternative strategies, and generates financial responsibility and better management. In support of this, it is further argued that public works are frequently financed by borrowed funds or by foreign aid in developing countries and that earmarking of such funds with built-in flexibility for management will be appropriate. On the other hand, the outlays involved are generally massive and are significant for demand management and market borrowing by government. Relinquishing control over them and
earmarking them may prevent effective functioning of economic policies and, from a technical point of view, may lead to immobilization of funds. Selection of projects implies that a number of other projects are available and will be taken up if funds immobilized by approved projects are released to them in the event of progress that is less than expected. In the context of annual budgeting, emphasis is on annualizing the outlays on projects in progress and new projects so as to achieve maximum utilization. Budgetary processes will therefore have to aim at achieving a reasonable compromise between the requirements of central agencies and those of the project authorities.

Another issue of funding relates to the stage when provision is to be made in the budget. Several procedures are in vogue. In some countries, a token budget provision is first made to obtain legislative and executive approval. After detailed costing and preparation, further amounts are provided in the budget by supplementary appropriations. In some countries, budget provision is made on the basis of full internal costing, while in a few others such internal costs and budget estimates provide a floor for bidding. Where tendered costs differ substantially from estimated costs, budget provisions tend to become dated even before the start of the project and lead to a distorted image of cost increases. In some countries if the tendered costs vary by more than a specified margin from the estimated costs, projects are withdrawn and design modifications are made to comply with overall resource levels. When such modifications are not feasible, project viability is reviewed again and decisions are then taken. The possibility of the variations between estimated and tendered costs has led in some countries to the adoption of a "limit of the cost" approach so that financial limitations could be kept in mind. In such cases, the budget process may advantageously be divided into a two-step process, the first step providing a "token" amount for fulfilling administrative formalities and the second step providing for tendered costs to reflect the likely actual costs.

**Budgetary process**

The requirements of public works budgeting at a normative level and on the basis of country experience may be considered in terms of a series of steps in the formulation, financing, and implementation of projects. The policy function of the budget implies a certain degree of
priority planning within the resource constraint and in terms of the desired level of public investment to serve economic policy. In procedural terms, this is equivalent to an annual request for the compilation of public works projects. Such a compilation should not be open ended but should induce the spending authorities to undertake priority planning. The planning undertaken in the spending agencies will differ from that undertaken in central agencies. Both are needed, with a view to achieving the necessary trade-offs. Formulation of designs and estimation of costs enable a clearer examination of the environmental aspects of the project and its role in the overall plan. Other considerations are the relative tempo of construction in various sectors and regions of the country, a recognition of intersectoral dependencies, and acceleration or deceleration where needed. From an economic point of view, the application of cost-benefit analysis and the ranking of projects within and among sectors provides a different dimension to priority planning.

The program function of the budgetary process consists of the preparation of the annual budget and of making provision for works in progress, for new works for which designs have been prepared and tendered, for minor works, and for maintenance expenditures. The annual budget is based on a work plan drawn up for each major construction project. Priority planning within the annual budget frame is dependent on the availability of sites, estimated total outlays for a year and their implications for demand management, and some balance between outlays for maintenance and those for new projects. Recent experience suggests that budget provision for maintenance is done in the aggregate without a firm basis for the actual requirements. Such notional estimates receive instant acceptability from the budgeteers but prove to be major problems later. In all these phases, organizational capabilities and their interaction with project costs need therefore to be kept under review. The annual budget should also have contingency funds to adjust for inflation and related cost escalations. During the year relevant budgetary controls need to be exercised either to ensure smooth functioning of projects or

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21 In a number of developing countries, procurement of sites is difficult and long lead times are needed. Underexpenditure in the public works budget, which is common, arises from an incorrect estimation of this factor.

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to arrange diversion of funds from projects lacking progress to other needy projects.

Project management

Even a budget system that has evolved to meet ideal specifications cannot ensure successful completion of construction activities unless it is accompanied by well-developed methods of project management. Project management is not meant to be independent of the other phases of administration, but is closely interwoven with them. Specifically, in regard to public works, it consists in the initial stages of developing feasibility studies on the proposed projects. This step is followed by a review to approve the designs and to ensure that costs are within the estimates. Project schedules, indicating network milestones and annual work plans, are also needed. During the implementation stage, actual progress has to be reviewed and revisions made.

An important function in project management relates to the overview of the contractual services and to the discipline enforced on them. Experience of both industrial and developing countries indicates that the implementation of this function is a common problem of varying magnitude. Part of the problem arises from the administrator's quest for flexibility, part from the contractor's search for fallback positions, and part from the launching of projects without complete designs and firm decisions. It seems that important decisions are made after the start of the project and are revised frequently. Inevitably, projects are delayed and become more expensive. Project management that puts adequate emphasis on comprehensive planning of designs, has firm commitments, and enforces discipline on contracts should eventually mitigate this problem.

Conflict vs. cooperation

Throughout the budgetary cycle, different functions devolve on the central and departmental agencies. The manner in which functions are allocated has often proved to be a controversial issue. The first question is whether there should be a central agency that is responsible for all governmental construction. Experience shows that a central agency would be ideal, in order to reap the benefits of scale. In several countries, distinctions are made between civil and defense construc-
tion, with construction of roads and bridges being handled by specialized agencies. Such a division implies that the scale of construction has grown too large to be efficiently handled by a single agency. Central agencies permit a high degree of coordination, flexible use of resources, priority planning, economic development of specialist skills, and promotion of government-wide standards. These special agencies have their miniature counterparts in the spending agencies and in the central agencies. A unit in the administrative agency is responsible for initiating action on projects and for processing them through the works agencies and the Finance Ministry. A unit in the Finance Ministry is expected to have sufficient financial expertise to monitor contracts.

In the exercise of the respective functions, conflicts have arisen between the Finance Ministry and the spending agencies. In some countries, the central agencies are concerned with the economic aspects of projects but detailed cost estimates form part of the responsibility of the administrative agencies. In others, finance ministries have specialized staff for the purpose and are associated with the spending agencies from the inception to the completion of a project. Both these types of systems have led to problems. The first type implies the delegation of such an extensive power that the requirements of the central agencies may only be partly met, while the second type reflects such extensive control that it may prove to be an irritant. The resolution between the central tasks and the administrative responsibilities of the spending agencies is not easy. The spending agencies cannot reconcile the many parts of the budget in a coherent scheme without some direction from central agencies. The absence of a framework and a decisive approach on the part of the central agencies leads to a great deal of administrative effort without result. Procedures emphasizing cooperation and joint efforts are clearly indicated.
In general, planning is of two types—substantive planning and fiscal planning. Substantive planning, which is also known as development planning, involves the planning of societal goals and objectives and the mobilization of natural, human, and financial resources needed for their achievement. Fiscal planning, which is narrower in scope and is one of the instruments of substantive planning, consists of planning future budgets—current and future budget decisions, the implications for financing, and the methods of obtaining the necessary resources and allocating them in accordance with overall national goals. This chapter considers the nature of development planning and its institutional, operational, and procedural relations with budgeting, as well as the role of budgeting in the broader framework of national planning. The discussion in this chapter deals largely with the experiences of developing countries, while the responses of industrial countries to planning are discussed in Chapter 7.

Development planning, which is now practised in one form or another in more than a hundred countries, has been viewed primarily as a feature of the developing countries.1 Planning in a general sense is, of course, common to all governments, although the specific emphasis and the techniques of planning depend on the prevalent political philosophy. In developing countries, planning is primarily concerned with the delineation of the role of the government sector in national economic development. In industrial countries, the govern-

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1For a complete listing of countries that have medium-term or annual development plans, see World Bank (1973).
ment's role as investor, regulator, and stabilizer has been a major influence on the planning of the private sector activities. In developing countries, the formulation of development plans and related strategies is a distinct activity, while in industrial countries, some of these functions have been allocated to budget agencies. In each case, problems have arisen in regard to the nature and form of government planning and budgeting. The persistence of such problems and the continuing search for new policy and institutional alternatives merit comprehensive consideration.

**NATURE OF PLANNING**

The issue that has not lost any vigor despite a long debate is, why plan at all? This issue has been revived so many times that one is reminded of Plato's anamnesis and the more graphic descriptions by George Santayana. The main reason for economic planning is the belief that the market has become anarchic, that it cannot provide stability or full employment, that scarcities would be fully exploited adversely affecting the common interests of the community, and that the goal of equity would not be reached. Associated with this is the recognition that the main objective of developing countries is to attain economic and social development, which in itself is a long-term task. If the achievement of this objective is to be undertaken and if development is to be orderly, it is necessary to establish priorities and set forth a plan of action consistent with the available resources; channeling resources to serve the broad goal of development or to improve the living standards requires deliberate planning efforts to ensure optimal results. In turn, these requirements contribute to the idea, as Myrdal noted, that "the state shall take an active, indeed, decisive role in the economy, by its own acts of investment and enterprise, and by its various controls—inducements and restrictions—over the private sector the state shall initiate, spur and steer.

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2Sanrayana wrote in *Tipperary* "Each generation breaks its eggshell with the same haste and assurance as the last, pecks at the same indigestible pebbles, dreams the same dreams, or others just as absurd, and if it hears anything of what former men have learned by experience, it corrects their maxims by its first impressions and rushes down any untrodden path which it finds alluring, to die in its own way, or to become wise too late and to no purpose."
economic development" and that policies would be "rationally coordinated and the coordination [made] explicit in an overall plan for a number of years ahead."³

If the main consideration for economic planning in developing countries is the need for orderly development, the main consideration in industrial countries in recent years is the need to minimize the ad hoc and piecemeal approach to economic management. The spread of government agencies and their functions has been so extensive in these countries and so pervasive that lack of integration has not only been "wasteful in its efficiency but outright harmful in its short-sightedness."⁴ As the lack of coherence in national objectives has proved to be a liability, economic planning is considered essential for providing guidance to the participants in the economy. Yet another factor that necessitates economic planning is the general uncertainty faced by the economy. The government has to reckon with this and initiate measures geared to deal with it. As the eighth French national plan put it "the cloudier the future, the more necessary the plan."⁵ The need for state planning has been implicitly accepted in the developing world, although there have been different approaches to the choices involved in resource utilization and in the forms of planning, as discussed below. In the industrial countries, particularly in the United States, the objections to state planning cover a wide ground. State planning is considered to be wasteful by some and infinitely worse than the free market mechanism because it imposes value systems and priorities that do not properly reflect the role of the community. Government intervention is believed to have been responsible for the alleged anarchy in the market.⁶ Implicit in these arguments is the fear that state planning may be tantamount to government coercion and "creeping socialism." The differences between those who favor or oppose state planning are fundamental. Given the choice, however,

⁴During 1975, serious efforts were made in the United States to organize a forum for national planning. For the above quotation and associated arguments, see Hubert H. Humphrey (1975), p. F12.
⁶Thomas A. Murphy (1975), p. F12. For a more recent exposition of the virtues of the market mechanism and the problems of planning, see Milton Friedman (1979), p. 289. Earlier exponents of this approach include Frederick von Hayek, The Road to Serfdom, and Ludwig von Mises, Socialism.
several countries have opted for formal planning. For countries that have adopted formal planning, the issue is academic; for countries that are considering its introduction, the distinction between the two choices may be vital.

Economic planning for development involves several choices—on the relative roles of public and private sectors, on the place of agriculture in the economy, on the relative importance of import substitution and export promotion, on the approaches to population control or its unrestrained growth, between economic stability and growth, and between growth and distribution. These choices are generally of a political nature. While economic forces are important, they are not necessarily the final determinants of choice. A combination of these approaches is used to formulate development strategy. The concern here is not with the development strategy but with the forms of planning and their implications for budgeting. The importance of development strategy needs to be recognized, however, for the failure or success of planning efforts is due equally to the strategy adopted and the technical or institutional factors.

GROWTH OF PLANNING

In the literature on growth, planning has been associated with movements toward independence and as arising after World War II. In reality, however, planning efforts started anew in the early 1930s at the time of the Great Depression. Planning efforts took place in both colonies and independent countries. In India, for example, the first effort was for a ten-year plan published in 1933, with the objective of doubling the national income.\(^7\) Mexico published its first plan in 1934. The Philippines set up a National Economic Council in 1935, with responsibility for the preparation of sectoral programs as well as integrated socioeconomic programs.\(^8\) These efforts were given further impetus with plans for postwar reconstruction, which were even initiated in some colonies during World War II. A reconstruction committee was set up, for example, in India in 1943. But, by and

\(^7\) For a detailed account of the growth of planning in India, see Premchand (1966b), pp. 130–35.

large, these efforts received added stimulus in the late 1940s both in colonies and independent countries. For example, the British Colonial Office formulated the first plan for development of its Caribbean islands in 1949 and made extensive grants for the purpose during the late 1940s and early 1950s. Countries in Latin America that were free from the ravages of war and the effects of colonization had initiated organized planning efforts by the early 1950s. Argentina prepared its National Economic Budget in the early 1950s. Mexico, which pioneered in the publication of its plan, subsequently carried out its efforts mostly at the departmental level until 1976, when national planning re-emerged. From the early 1950s, national planning also received a substantial boost from government and international aid agencies that preferred to make loans and grants in accordance with national development plans.

The economic approaches of the plans and the underlying assumptions have evolved over the years. In the initial period, formulation of the plans was influenced by the approach of Harrod and Domar, which implied that parameters such as capital/output ratios and saving as a ratio of GNP were likely to remain steady and that there need be no apprehension of diminishing returns. By the mid-1950s, planning became synonymous with industrialization. Later, Rosenstein Rodan's emphasis on "big push" as a leverage for the rest of the economy lent support to the approach for industrialization. In due course came Myrdal's "circular cumulative causation" and Rostow's "take off" philosophy that growth, once initiated, would feed on itself. Planning for economic development was considered essential for solving a wide variety of objectives, such as acceleration in the rates of saving and capital formation, expansion of employment, improvement in the balance of payments, diversification of domestic production, and self-sufficiency in food and associated goods. By the mid-1970s, the goals of growth were tempered by a recognition that equal attention to equity was needed. Over the last three decades, plans that were initially considered to be identification symbols of independence have acquired multiple dimensions. Although the major goals continue to

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9See Barbu Niculescu (1958). For a description of grants and the status of finances in some of the West Indies, see J. R. Hicks and U. K. Hicks (1955); and A. R. Prest (1957).

10For an account of the subsequent efforts and problems, see John J. Bailey (1980).
be increased investment and growth in GNP, emphasis has also been devoted to the less quantititative aspects of growth. All these have also influenced the techniques adopted for planning and, therefore, the approaches to budgeting. It is in order that these are considered in terms of the types and techniques of planning and the implications for budgeting.

**PLANNING: TECHNIQUES AND INSTRUMENTS**

Economic planning is essentially of two types—planning by inducement and planning by direction. The former places reliance on the pricing mechanism, modified by taxes and subsidies to bring about needed investment in directions that are generally accepted. This approach is an antithesis of planning by direction, which implies a regulation of all aspects of economic life. Adherents of this latter school of thought, who are also inspired by a paternalistic view of the role of government, contend that the price mechanism is faulty, that the adoption of laissez-faire policies does not promote the welfare of the community, and that the state should assume a more active role. Supporters of the price mechanism approach suggest that the main problem of economic development is to motivate the millions of people who constitute the private sector and that this could be achieved more easily by incentives than by administrative fiat. A more pragmatic view is that there are areas where positive government stimulus is necessary, but there are also a number of areas where controls could be counterproductive and could work as impediments to economic efficiency and growth.11 The extent of support given to these two major themes and the purposes of the plans determine the specific techniques of planning adopted by governments.

Two types of planning have emerged, depending on varying economic and social systems. Countries following the directional approach have become centrally planned economies, while those that relied on a mixture of direction and inducement have come to be considered as mixed economies (see Table 11 for a schematic

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11 For an application of the relative effects of controls and inducements, particularly in the area of foreign trade, see Emile Depres (1973). Chapter 9 (pp. 133–45) of the book is a reproduction of Depres’s memorandum, “Price Distortions and Development Planning: Pakistan,” addressed to the Planning Board, Government of Pakistan, 1956.
framework of the approaches and techniques of planning). In centrally planned economies, the principal means of production are owned by state enterprises and institutions, and the activities and tasks of each production unit are reflected in the national plan. Such plans involve detailed estimates of material balances with their actual and intended use. The main purpose of the material balances method is to maintain equality of supplies and utilization of resources over a specified period. The method is employed at different levels of aggregation—for example, at the sectoral and national levels. At both levels, a balance is needed between resource availabilities and uses. Central planning involves the use of measures for the determination of aggregate output, investment, targets for each sector, central determination of prices, and regulation of personal incomes. This system, with its emphasis on detailed structuring (or, perhaps, overstructuring) of the economy is practiced in socialist countries. During recent years, however, there has been a gradual relaxation of central controls in those economies, and increasing reliance is placed on the market mechanism or its proxies. The budgets in these countries do not differ from the plans and are essentially financial expressions of quantitative targets.

Planning in mixed economies implies the adoption of two approaches—a detailed plan for government outlays and informal
guidance to the private sector on its activities. The formulation of the overall objectives and the specifications of priorities—and even indications of resource plans and sectoral targets—are prepared by the government, but its decisions do not replace the private sector decision making. Decision making in the private sector is sought to be influenced by incentives and selective use of fiscal instruments. An eclectic combination of detailed and direct planning of government activities and use of the market mechanism therefore influences private sector operations. A variant of this approach is the indicative planning utilized in France during the 1960s. The French approach stressed the process of influencing private sector operations through persuasion, while areas such as consumption were to be regulated by fiscal and monetary mechanisms. French indicative planning was undertaken in two major steps. The first was to determine the feasible growth rate for the economy as a whole. The second consisted of an analysis and assessment of the requirements of each industry in terms of its linkages with the specified rate of growth before checking the mutual consistency of overall, as well as sectoral, rates of growth. The second step was a collective exercise in which both public and private sector industries participated. The main advantage of this approach, which is also called planning by concertation (l'économie concertée), is that planning is viewed in a broader framework beyond the traditional choice between the market mechanism and direction, and as a horizontal process of participation and consent. Planning then becomes possible with the advice, participation, and informal approval, which is in some ways morally binding. It encourages mutual exchange of information and facilitates the coordination of activities. In view of the greater involvement of government in economic management and the growing difficulties faced in that task, particularly the countervailing power of trade unions and associated wage rigidity, there has been a renewed plea for a greater spread of concertation.\(^\text{12}\) Concertation imposes some limitations on the government policymaker. In particular, it implies that outlays on infrastructural elements must be consistent with the agreed rate of growth for various sectors. The budget in such circumstances is necessarily subordinate to the framework of planning.

Plans in developing countries, reflecting the predicaments of a mixed economy, tended to be in the initial stages what were derisively called "shopping lists." In the early 1950s, plans were aggregations of the projects that were already under implementation or that were awaiting implementation. This phenomenon was not isolated but was broadly applicable to countries in Asia and Africa. Effective unity of aims and basic priorities was not attempted in a coherent way, and the tentative development plans underlined the need for an aggregate economic framework and for formulation of priorities. Meanwhile, lack of statistical data, which prevented the rigorous economic analysis of the proposed strategy, was partly compensated for. By the middle and late 1960s, the role of government in economic management received better attention and plans came to be evolved within the national account framework to ensure consistency. Conventional plans sought optimal solutions, but a macroeconomic framework was lacking. Formal econometric models, reflecting the interrelationships among the important variables of the economy and for which the parameters are estimated by an analysis of time series of data, had therefore come into vogue.\(^\text{13}\) By the early 1970s, macroeconomic analysis and econometric models had come to be firmly recognized, although the usefulness of the models was vitiated partly by the methodology adopted and partly by deficient statistical data.

There has been a growing recognition, over the years, of the importance of sectoral planning, with specific attention to intersectoral linkages and the need for their harmonization. Sectoral planning permits the formulation of clear subgoals within the previously established framework of the economy. It also helps to direct resources to areas where they are most needed. In practice, however, the full potential of sectoral planning has not been achieved in many countries for two reasons. First, there is the limitation of data, and often sectoral planning has been restricted to the more obvious sectors or to those that have better statistics. Second, in some cases, it is feared that overconstrued plans might reduce flexibility in terms of the revision of plan targets. However, most development plans go through the motions of the formulation of strategies for various sectors, which are then translated into specific projects and programs in the public sector.

Sectoral planning places greater responsibilities on the tasks of budgeting in that the financial aspects of each sector and its components are required to be reviewed at each stage of the planning and budget cycle.

The time span of the plans has also, over the years, undergone a change. In the early periods, when plans were largely consolidations of existing and proposed projects and when there was no macroeconomic framework, plans were for a five-year period. By the early 1960s, however, it became apparent that difficulties were being experienced in the implementation of medium-term plans and that they were not sufficiently flexible to permit greater attention to short-term problems. Unexpected declines in exports or foreign aid receipts made adherence to the medium-term plans difficult. Furthermore, in some countries, the implementation of medium-term plans contributed to exhaustion of the available foreign exchange reserves and common resort to deficit financing. Such a policy led to serious imbalances and inflationary pressures in the economy, and it became clear that policies and plans better adapted to the short term (annual plans) were necessary. Yet another factor that contributed to the adoption of annual planning was that the formulation of medium-term plans took longer and the political processes of deliberation on them were often slow. During the mid-1960s India showed greater enthusiasm for annual plans because of this difficulty. Political instability and economic uncertainty, as well as the desire to have greater flexibility in planning and to achieve greater synchronization with the annual budget, contributed to strengthening the annual plan. While the reasons in each country may be different, France, India, the U.S.S.R., and Yugoslavia were among the countries that first introduced annual plans. Several Asian and African countries adopted a similar approach. In some countries, medium-term plans were replaced by annual plans.

The purposes of the annual plans are to facilitate the conversion of general policies into specific policy actions, to provide a corrective for

14 For a case study of Tunisia during this period, see Sadak Bahrour (1971), pp. 60–95.  
15 For a review of the approaches to the Asian countries, see Economic Commission for Asia and the Far East (1969), p. 31. In the early years of the introduction of the technique, it was considered a "weak area" requiring greater attention (ibid., p. 32).
changes in the economic situation and, more significantly, to be a plan of action. The medium-term plans were not to be considered as being immutable or as being implemented mechanically. Each annual plan was to have its own focus but was not to be seen as an independent phase. It was a link that provided continuity and permitted change. Relative to the medium-term plan, it had some limitations, however. For example, saving, which is mainly determined by production, is an exogenous factor in the annual plan but is a part of the medium-term plan. Operationally, the annual plan consists of an assessment of progress in both physical and financial terms relative to the plan targets, an analysis of current developments, and a forecast of the immediate future. Its role is to review the plan projects, so that changes can be made and policies aimed at specific problem areas. The annual plan also pays detailed attention to resource constraints and crucial scarcities such as foreign exchange. In all these endeavors, the purpose is to adjust government policies for maintaining budgetary and economic stability and the pace of development and for ensuring consistency in the sectoral framework. Implications for annual budgeting are, in theory, clear. Inasmuch as it is an operational framework, it permits greater rapport with the budget and reduces some of the load that budgets have to carry in a medium-term context. The success achieved is, however, dependent on the way in which annual plans have fulfilled their expectations.

The techniques adopted for planning are usually described in terms of planning from the top down, planning from the bottom up, and mixed systems. In reality, however, it is often a mixture of planning from the top down and planning from the bottom up, depending on the areas of the plan. Broad national objectives tend to be given from the top or could be a meaningful aggregation of the preferences of the various levels of government according to the political leadership. During some periods of national leadership, for example, in India, Korea, and Tanzania, the framework of objectives may be specified at the top and ratified through the normal consensus framework. In regard to economic analyses and projections, as well as the use of econometric models, direction tends to be more from the top. The projects and programs included in the plan are generally built up from the bottom and are processed through various stages of review and analysis. No central authority can hope to compile the whole plan from the top alone, but in the final specification of targets, however, it is
quite likely that the wishes of the "bottom" are not given due regard and, therefore, the agencies might feel that the targets have been imposed from the top. The formulation of targets often involves a goal toward which the agencies should strive and, therefore, may be set higher than the agencies consider feasible. This factor contributes to the expanded image of planning from the top down.

The advent of development planning has also led to the establishment of new instruments of budgeting. Traditionally, government budgets consisted of a revenue budget (receipts), a recurrent budget (expenditure), and, in some cases, a capital budget. After development plans came into vogue, some countries used the capital budget as a means of incorporating a major part of the plan outlay. In a few countries, development budgets became coterminus with the plan. Similarly, to cover the extensive loans and investments, investment budgets were set up. To facilitate consideration of the balance of payments and to conduct more orderly management of foreign exchange resources, foreign exchange budgets, or finance budgets, came into being. Also, to consider the overall implications of plan finances for monetary and credit management, many developing countries established finance and credit plans. These were, however, informal, and did not become part of the budget that was approved by the legislature. The growth of the variety of budgetary instruments illustrates the complexities of development planning and its implications for budgeting.

BUDGETING AND PLANNING

Budgeting in the public sector had its origins in the needs of legislative accountability. Its focus, which was on the allocation of resources to the various agencies and on the provision of a basis for control, was different from the approaches in the commercial world. In commercial firms, budgeting was concerned with the anticipation of investment needs, cost efficiency, and assessment of working capital and other investment requirements. With more progress in industrial activities, planning had come to be associated in the commercial world with optimal selection of product markets, with technological and market responsiveness, and with threats of discontinuity in each of these areas. Planning became a part of the responsibilities of administrators, and the philosophy of management came to be
symbolized by the acronym POSDCORB (planning, organization, staffing, directing, coordinating, reporting, and budgeting) that has long since become a part of folklore. In due course, the budgetary process became one that brought together for analysis the problems and the information relevant for solutions, as well as the administrative structure through which the decisions would be implemented, controlled, monitored, and evaluated.

Planning, in its simplest form and as it came to be used in governments, is considered as organized, rational thought that is essential for a determination of the national objectives, the instruments to be used, and needed inputs. In more diversified forms, planning is considered as a projected course of action, as a means of reaching an end, as a special process for reaching a rational decision, as full utilization of all the materials of the community, as an art, and as a process of preparing a set of decisions for action in the future directed at achieving goals by optimal means. Budgets and plans are, therefore, facets of the same process. Budgeting without planning ceases to be a plan of action, and plans that do not have a realistic recognition of the budgetary constraints have little functional value. Each disciplines the other, and the end products should ideally bear the imprint of both.

In practice, however, plans and budgets are different, reflecting the approaches, content, and purposes of each. The plan is concerned with the whole economy, while the budget is concerned with the government sector. The difference between the two is less in centrally planned economies, where the state-run economy may not be very different from the total economy. The time span and the perspective of time may also be different. Budgets are usually made for one year. No budget can, however, be formulated strictly for a year, because it leaves a legacy for the future; it is not as though the slate is wiped clean each time and a fresh start is made. The budget is like a myopic patient whose view of the future may be indistinct. The plan, as noted earlier, can also be annual, but it views with greater clarity the implications of today’s actions for the future, as well as the requirements for the future.

16 For an interesting review of these definitions, see Yehezel Dror (1963), pp. 44–58; and Bertram Gross (1962).
Both plans and budgets are concerned with policy analysis and allocation of resources. The differences lie in the combination of economic and financial aspects. In planning, the economic aspects dominate, while in budgeting more attention is paid to financial aspects. The two cannot be viewed in isolation, but degrees of expertise and tradition have an influence on their approaches.17 Plans approach the economy in terms of various sectors. Budgets view them in terms of systems of control over the use of funds by government agencies. Plans provide a conceptual framework and represent the thinking process. Budgets are operational documents on the basis of which laws are drawn up, funds appropriated, contracts made, and funds spent and accounted for to the legislature. Over the years, plans have developed their own accountability to the legislature. Plans are debated by the legislature, but the purse strings are released only through budgets. In the context of a plan, budgets proceed on the assumption that goals have already been established and they become subordinate to the planned objectives. Plans are the quantitative expressions of governments goals, but the determination of the financial resources and the responsibility for ensuring the implementation of programs are a part of the budgetary framework. Essentially, therefore, while all budgets are plans, not all plans are budgets. The preparation of both takes place within a specified timetable, but the relative flexibility of the plan permits a deductive approach, while budgets, constrained by the short period within which they have to be made, tend to be inductive. In philosophical terms, the two tasks complement each other.

The functional symbiosis should ideally be reflected in organizational forms as well. As planning came to be organized, however, it took a different form and came to be established in several countries, separate from the finance and budgetary agencies. Considerations that influence this approach range from political ones to those more pragmatic. Budgeting has been a part of government organization for a long time and has well-established practices, but these practices are not considered entirely appropriate for the new vision needed. In India, it was recognized that "we do not at present possess either sufficient knowledge and statistical information or sufficiently exten-

17See Gerhard Colm (1968); and A. W. Johnson (1959), pp. 145–53.
sive control over economic activity," and it was felt that a separate body directly responsible to the Cabinet would be more appropriate. Planning was to be undertaken "through an organisation free from the burden of the day-to-day administration but one which is in constant touch with the Government at the highest level."18 Similar considerations prevailed elsewhere. The routine approaches of the budgetary agencies, which traditionally were more concerned with the limited objectives of economy and regularity, appeared obsolete for carrying out the new challenges that required greater awareness of social, economic, and technological developments. In some countries, planning was to be undertaken for the whole country, implying the need for greater and continuous coordination between various levels of government. It was believed that budget and finance agencies, which are a part of the government, would not permit the desired coordination and might give the impression of vertical integration. Planning bodies were, therefore, organized differently and were expected, in principle, to serve the requirements of state and local governments. However, as the full potential and implications of these proposed organizations were not too clear, it was considered better to organize them as advisory bodies, with the final decision making left to the normal government channels.

Over the years, the organizational, philosophical, and policy differences and operational divergences between planning and budgeting agencies have, in many countries, generated a series of problems that affected both the plan and the budget, as well as the outcome of both.

DIVERGENCES BETWEEN PLANS AND BUDGETS

The budget in the context of the development plan has a policy function and a program function. The policy function involves determination of the size of the government budget and of the composition of the outlays. The program function ensures that the programs and projects in the plan are included in the budget and that results expected from the outlays are actually achieved. In an ideal situation this would be true, but a cursory glance at any plan indicates

that there is a vast difference between ideal and actual situations. Depending on the degree of optimism or pessimism of the analyst, the situation could be interpreted either as flexibility of the instruments to respond to the changing situation, or as failure of the instruments to respond because they had not adequately anticipated the situation. Although it may appear paradoxical, both are true. Over the years, economies have been buffeted by crosscurrents that have required changes in plans. Plans and budgets, for their part, reveal that they have not fully anticipated some of the developments in the economy. These conclusions are inevitable on the basis of hindsight, but it is debatable whether a better prognosis could have been made in those situations. The countries that experienced success might illustrate better planning and, conversely, those that experienced stagnation or declining rates of growth may have had bad planning or policy advice. Successes or failures are easier to explain after the event. But success might not lend itself to replicative treatment, because, as noted earlier, institutional differences among countries act as either constraints or as locomotives. The purpose here is to examine the divergences between budgets and plans, as well as the extent to which they are influenced by differences in planning, procedural, and organizational factors.

An important area in which development plans and budgets are expected to be congruent is "development finance," which comprises resource mobilization and resource allocation. In a large number of developing countries, both development plans and budgets estimate revenues in terms of public saving (or balances from current revenues at rates of taxation prevalent before the plan), surpluses from public enterprises, external resources (including borrowing from abroad), additional taxation proceeds, and the extent of deficit financing. Revenue planning, as noted earlier, has traditionally received neither due importance nor the attention of the public, partly because of its arcane nature and partly because of the organizational division of labor. Collection of taxes has been the traditional preserve of the revenue agencies, and the planning agencies had neither the power nor the technical severity to carry out the necessary financial planning. This has had a twofold effect. First, planning agencies were content to draw up resource estimates in aggregate, leaving the more technical work to the revenue agencies. Second, in some countries where new resources such as external aid were concerned, planning organizations acquired
control over their management. In some countries, such as the Islamic Republic Iran, allocation of revenue was also transferred from the revenue or budget agency to the planning agency. Revenue planning does not require a transfer of the respective jurisdictions to the planning agencies but it implies that it should be done with realistic foundations. Additional revenue has been obtained with a greater degree of success by taxation measures than by other means. For example, in India, estimates of additional taxation were fulfilled (and even exceeded) during the second and third five-year plans and the following annual plans. In some other countries, however, this was not true, as the budget did not "incorporate the overall policy measures required for the success of the plan." This was, in turn, due to the fact that the planners were apt to assume that needed efforts would be made but had not paid heed to political difficulties. Although distinctions are drawn between planners and budgeteers, in effect, neither role is independent and each involves a little of the other. Indeed, in India, estimation of resources for the plan is a common responsibility of both planning and finance agencies.

Estimates of balances from current revenues, surpluses from public enterprises, and foreign aid included in both plans and budgets have proved to be too optimistic. Plans often did not have the necessary detail or specifications nor did they take into account the rate of growth of expenditures. India in the mid-1960s and Kenya in the mid-1970s assumed in their development plans that the rate of growth in nondevelopmental expenditures would be restricted to 3.5 percent annually, but this proved to be vastly underestimated. Revenue from public enterprises represents a major area which is considered in Chapter 14. Foreign aid is often pegged at a high figure as a reflection of the requirement for aid or as a goal rather than as a practical matter. Thus, the whole resource base of the plan tends to be unrealistic. As a result, budgets came to act as major correctives for the plan and for the economy. But, as the size of the plan was determined by resource availability and became, in due course, fixed in terms of its imperatives, the implication was that the plan had to be carried out even if its execution required resort to massive inflationary finance. Another important aspect was that planning and budgeting were

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undertaken as financial exercises, with little or no attention given to the impact of proposed resource mobilization on productive activity, consumption and distribution, and inflation.

Resource allocation also reveals a number of divergences between the plan and the budget. Two features dominated the early plans. Unrealistic targets were set for outlays which strained the capability of the administrative machinery. Plans were also vague and did not always represent specific investment decisions related to the national objectives. This initial situation may partly have been due to a desire to minimize conflict but, to a major extent, it was due to time schedules that would not permit fulfillment of the ambitions. Although some of these problems have been mitigated, experience over the past three decades shows that divergences between plans and budgets were not surprising at all, given that plans were not sufficiently articulate and budgets had to compensate for them. Whereas, in the ideal setting, budgets would follow the precepts, in the everyday world, it appeared that budgets had to compensate for the plans. Specifically, the plans did not offer a consistent investment frame and the amount of detail varied from sector to sector. More significantly, projects and programs that had not been reviewed thoroughly were included in the plan. As inclusion in the plan acquired a legitimacy of its own, they also had to be included in the budget. For example, about one third of the outlays provided in the budget of Bangladesh in 1976/77 were for unapproved, or as yet unexamined, projects. Apart from the implication of a lack of advance programming, this meant that scarce resources were allotted to programs that were not presumably ready, while those that were ready for implementation were denied allocations. To some extent, this was due to the inordinate emphasis on financial targets in which operational agencies felt obliged to try to include programs that had not been properly evaluated.

In some countries the determination of the annual size of the budgetary outlays was sought in terms of the levels indicated in the

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20 For a review of the experiences of several Asian countries, see Dennis A. Rondenelli (1978), pp. 45–74. See also Edward Mason (1964).

21 In Japan, for example, the medium-term plans prepared by the Economic Planning Agency were frequently used by the spending agencies to buttress their arguments for inclusion of their programs in the budget. Apparently, however, the success of this strategy was limited. See John Creighton Campbell (1977).
plans. However, as these were not adjusted for inflation, for the economic climate, or for slippages in implementation, the outcome of the budgets tended to be different from the plans. Implicit in the process has been the relatively low attention to the annualization of outlays. While part of this has been mitigated, depending on the progress made in formulation of plans, the plans themselves have not been without problems in specifying the annual amount of the outlays. A consequence of this approach has been the vast shortfalls in plan expenditures. For example, in the 1970s, the budget of Sri Lanka routinely provided for a 20 percent underexpenditure in its plan outlays to accommodate the built-in overestimation. Yet another feature was that the plans had not taken into account the continuing outlays on completed projects; lack of recognition of this led to distortions in decision making and to increased budget deficits. A significant shortcoming of the plans is the lack of contingency plans for carrying out short-term adjustments in expenditures when warranted by resource constraints and it became, by default, a responsibility of the budgets.

At a procedural level also divergences are to be found between plans and budgets. Different procedures and timetables are adopted in various countries for the compilation of the plan or development budget and the current budget. In some countries, development budgets are compiled by the planning agency and the current budget is determined by the finance agencies. The review in the planning agency emphasizes economic aspects, and that in the finance agencies emphasizes the financial side. As the respective agencies usually work in isolation, in some cases, a vast area lies between the two. The current budget is more detailed, while often the development budget is brief. The structure of the budget is also different from the plan. Harmonization of approaches to budget making has been one of the main aims of budgetary reforms since the early 1960s, but problems persist. A source of aggravation over the years has been the link between the annual plan and the budget. Ideally, the annual plan should take stock of the economy and provide the needed guidance for the formulation of the budget. In practice, however, because of politics and different timetables, annual plans have come to be prepared after the budget. Thus, plans cease to offer a consistent framework or the visionary guidance for the formulation of the budget, in some cases,
the planning responsibility shifted to the budget agency. In many countries, the procedures for annual budgeting have recently improved. Specific mention should be made of the overall resources budget prepared annually in Korea, which sets priorities and allocates funds for various sectors.

The divergences between plans and budgets are, in part, ascribed to the separate organizational forms of the two agencies, which reflect the fundamental differences in the approaches of planners and budgeteers. Budgeting, in this school of thought, is viewed as a specialized way of looking at problems and involving certain values relating to fiscal policy and coordination. The budgeteer is believed to be conservative and, therefore, inclined to reduce expenditures, being concerned with annual increments. The planner, on the other hand, is considered a big spender, who would be inclined to support increased outlays. In his decision making, the planner might be more rational, stressing allocative efficiency. Implications of these approaches have already been considered. Extremes of these portraits have been drawn in the literature, and the differences between plans and budgets have been ascribed to them.22 It was pointed out earlier in this chapter that it is too simplistic to view these divergences as an issue only between two organizations, as in practice it appears that decision making is fragmented among different instruments and units that are separately organized and that the problems relate to techniques, as well as to coordination among the various divisions in government. More important is the fact that the divergences have, over the years, contributed to the establishment of new values in administration and to new problems. These pervasive problems need more attention. The most important is dualism.

22Caiden and Wildavsky (1974) suggest that the Finance Ministry is likely to acquire accountants, lawyers, and low-level technicians, and that the planning bodies are likely to have economists and others "whose rationale is to overcome the regular apparatus," p. 241. This implies a value judgment that personnel other than economists do not function too well in planning and that economists assume the responsibility for reforming the government. Admittedly, neither proposition is sustainable: several planning bodies have more administrators than economists and some budgetary agencies that have shown greater reliance on lawyers have done very well (for example, the Federal Republic of Germany).
PROBLEM OF DUALISM

Boeke in his pioneering work on dual societies\(^2\) essentially referred to the distinct cleavage of two synchronic and full-grown social styles that in the normal, historical evolution of societies are separated from each other by transitional forms. He made the qualification, however, that one of the prevailing systems—as a matter of fact, always the most advanced—“will have been imported from abroad and have gained its existence in the new environment without being able to outst or assimilate the social system that has grown up there.” He also suggested that there was bound to be a clash between imported and indigenous styles. In extending this approach to financial management in government, it should be recognized, as described earlier, that these systems have undergone several adaptations in their implementation in developing countries. Also, what occurs between traditional styles of financial control and the newly introduced systems of planning should perhaps be considered as conflict rather than clash. A clash implies a fight in which one of the contenders has to yield to the other. Although Boeke applied his dualism thesis primarily to emphasize the contrast between subsistence and exchange sectors, more recently there have been attempts to extend the approach to a wider range of economic and social dichotomies.

Dualism, which reflects two separate approaches to budgetary matters, is largely the result of the continuation of traditional institutions and related approaches, on the one hand, and the emergence of new institutions and approaches reflecting the requirements of development, on the other.\(^2\)\(^4\) The simultaneous existence of these two strands and their everyday working has a vast impact on the very structures of institutions, as well as on the approaches to policy formulation and the implementation of policies. While it is debatable


\(^2\)\(^4\) Hoselitz (1963) observes “On the one hand, the time-honored fashioned ways of government and administration are extolled, and at the same time the pressure for economic advancement places stress on the development of a streamlined highly rationalized modern bureaucracy” (p. 183). He does not, however, undertake any assessment of whether indeed the new institutions that have come to be organized have the features of a modern bureaucracy or are only variations of the existing institutions. See Hoselitz, Bert, in J. La Palombra, ed., Bureaucracy and Political Development (1963).
whether dualism of this type has impeded or facilitated economic
development, it has undoubtedly given rise to numerous problems
and, to some extent, avoidable conflicts.

Based on the experience of a number of developing countries, certain
aspects of dualism may be enumerated. First, reflecting the economic
and institutional demands, dual and multiple budget structures have
emerged—and in their wake, dual standards for budget formulation
(Table 12). This dualism has contributed to a predictable “project gap”
in the development (or capital) budget, while conservative attitudes
toward the current budget have strengthened the desire to resort to
escape mechanisms. Second, as a consequence of dualism, a new type of
distribution of power has emerged. Development projects are often
accompanied by a substantial decentralization of power to the
operational and managerial levels, while powers in regard to spending
on the current budget continue to be heavily centralized in the
ministries of finance or budget bureaus. Third, financial control has
changed so that the degree of control varies with the nature of the
currency. It tends to be relatively lax when expenditures are incurred
in domestic currency and becomes rigid and centralized when
expenditures are in foreign currency. Fourth, dualism also has given
rise to a number of institutional problems. For example, the
traditional systems of accounting and auditing were not able to
develop new approaches to the treatment and evaluation of expendi­
tures. Consequently, planning organizations developed their own
evaluation institutions that occasionally overlapped with audit
bureaus. Dual approaches have, over the period, resulted in the
hardening of the respective standpoints and the growth of distinct
spheres of institutional activities. But the way in which such
hardening has come about is not by a recognition of dualism and its

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25 A similar problem was experienced by the industrial countries in an earlier
period. For a discussion of these experiences, see E.L. Normanton (1966).
26 Riggs argues that “the phenomenon of development involves the differentiation
of separate structures for performing services and that in doing so structures adapted
from western models could come into existence. The older institutional base of a
traditional system, however, lingers on. Although eroded and embattled, it struggles
to remain alive, to retain positions of influence. . . . We find then, in the transitional
society, a dualistic situation. Formerly, superimposed institutions patterned after
western models coexist with earlier indigenous institutions of a traditional type in a
complex pattern of heterogenous overlapping” (see Fred Riggs “Bureaucrats and

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extended prevalence in government but as a part of systems politics—a struggle over the processes by which decisions or policies are made rather than on the substance of policies. Policy differences become major issues that may cut across government, while minor differences about who should make decisions tend to become irritations leading to delays and unprofitable activities.

Aspects of systems politics emerged in the initial stage, as finance agencies felt that their traditional power was eroded by the planning machinery. But their reactions were ambivalent. Sometimes they refused to concede the power and what was lost they sought to retrieve at the various stages of planning and budgetary processes. This meant determining the size of the plan and its financing by the finance ministry, or determining the annual budget ahead of the annual plan, and planning bodies were left with the more routine business of reviewing development projects. To a great extent, the shift of power depended on the respective political strengths of finance and planning agencies. Available experience indicates that there are planning agencies that have precedence over finance ministries, and countries where the finance ministry continues to hold its traditional primacy. The contribution of systems politics was to make the planner leave the postulated rational approaches and to make greater adjustments to the political environment. Although these adjustments implied a different kind of rationality, it also showed that planning could not work in isolation and was a part of the real world.

ALTERNATIVES: INTEGRATION OR SEPARATION

Conflict between organizations and the prevalence of systems politics have contributed over the years to situations that are

Political Development: A Paradoxical View," in La Palomba (1963), p. 123). Riggs does not extend his analysis to inquire whether such a coexistence would be peaceful or otherwise. He does not also consider whether coexistence would be rendered any easier and transition made smoother, if those institutions modeled on western practices were hybridized to meet local requirements and to mix easily in the indigenous milieu.

27 There was a view in India that the relationship between the planning and finance agencies was one of a division of responsibilities—finance responsible for the implementation of the plan, while the responsibility of the Planning Commission was that of analysis, review, and advice. See Premchand (1966b), p. 133.

28 For an analysis of these aspects, see S. Kenneth Howard (1970), pp. 151–52.
Table 12. Dualism in Government Financial Management

<table>
<thead>
<tr>
<th>Area</th>
<th>Traditional Instruments and Approaches</th>
<th>Recent Instruments and Approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget structure</td>
<td>Revenue budget</td>
<td>Development budget</td>
</tr>
<tr>
<td>Coverage</td>
<td>About 70 percent of the budget</td>
<td>About 30 percent of the budget</td>
</tr>
<tr>
<td>Time span</td>
<td>Usually one year</td>
<td>Can exceed one year</td>
</tr>
<tr>
<td>Nature of decision making</td>
<td>Piecemeal; qualitative; and restrictive</td>
<td>Comprehensive; quantitative; and forward looking</td>
</tr>
<tr>
<td>Influence on decision making</td>
<td>Emphasis on current account surplus</td>
<td>Compulsions of economic growth and underlying relationships with foreign aid programs</td>
</tr>
<tr>
<td>Deployment of scarce resources, e.g., foreign exchange, manpower</td>
<td>Restrictive practices</td>
<td>Greater preference shown for development projects</td>
</tr>
<tr>
<td>Budget presentation</td>
<td>Line-item presentation of estimates</td>
<td>Broad program-based presentation</td>
</tr>
<tr>
<td>Budget management</td>
<td>Tight control over items</td>
<td>Greater delegation of financial powers and management responsibilities to implementing agencies</td>
</tr>
<tr>
<td>Progress reporting</td>
<td>Restricted to financial outlays; infrequent</td>
<td>Analysis of slippages and cost overruns; frequent follow-up action</td>
</tr>
<tr>
<td>Accounting</td>
<td>Greater preaudit, owing to tradition</td>
<td>Lower preaudit and absence of accounting detail, owing to nondevelopment of accounting standards</td>
</tr>
<tr>
<td>External audit</td>
<td>Routine appropriation and financial audit</td>
<td>No new approach</td>
</tr>
</tbody>
</table>

admittedly not efficient and may have even functioned in such a way as to divert attention from more important policy issues. The solutions to the problems were sought at one stage through integration of the two functions. The proposals for integration were of two types—that
planning should take over the budgetary functions and that budgeting should also include planning. Although the problem itself was perceived to be primarily applicable to developing countries, the theoretical foundation for both came from western democracies. Bloch-Lainé argued that, regardless of the extent of consultation between budget and planning agencies, the existence of the former with final responsibility concerning public expenditure could itself be a negative force and might oppose the more expansionist views of the planning agency. He, therefore, advocated a Ministry of Planning incorporating the sections of the Ministry of Finance that exercise financial control, thus ensuring that the annual budget would be integrated with the plan. Variants of this approach are to be found, in practice, in Korea where the Bureau of Budget functions as a part of the Economic Planning Bureau. In Brazil, the Ministry of Planning is responsible for the annual budget. A less sophisticated version is that the planning agency is responsible for a part of the budget. This practice, as noted earlier, has actually contributed to dualism.

Similarly, in the early stages of development planning, programming, and budgeting systems (PPBS) in the United States, planning was included to define all the functions of budgeting and budgeting was considered merely as a determination of men and materials and provision of resources in the budget (see Chapter 11). The planning phase itself was to comprise appraisal and comparison of various government activities in terms of their contributions to objectives and related aspects. The agency that should undertake this was not clearly specified nor was such a specification considered necessary, as there was no separate planning agency in the United States. The work was undertaken as part of the annual cycle with appropriate subdivisions for the planning, programming, and budgeting steps to ensure an orderly approach. Planning was to be an integral part of the system and was to be undertaken by the budgetary

29 See F. Bloch-Lainé (1962). Also see, G. Denon (1968), pp. 241–42. A more recent exposition of a similar view is to be found in Stephen Marglin, Partha Daspagra, and Amartya Sen (1972). While recognizing that budgeting is the cutting edge of the national planning sword, they felt that the finance ministries are often conservative, old-fashioned, and preoccupied with short-term issues, and therefore suggested integration as the most important step for the introduction of any quantitative analysis.

30 See David Novick (1965).
agency. This ambitious approach was influenced, among other factors, by the fear, on the one hand, that a widening of the gap between planning and budgeting tended to generate an air of unreality by a compulsive need for breaking away from the traditional modes, and, on the other, by the views of economists, who felt that planning involved a greater degree of centralization that, in turn, was helpful to government decision making. It appears, however, that this approach also ignored the institutional implications of such integration, one problem of which is the fact that the budgeteer, by tradition, is ill equipped to be a visionary. More significantly, there was a danger that operational requirements and procedures of budgeting might drive out the creativity required for good analysis. Even integration requires coordinating devices between the two broad functions and unless these are properly attended to, integration by itself will not solve the problems. Integration can also lead to the creation of a monolithic organization that can be more problematic. Practical experience reveals that developing countries ranging from the Bahamas to Zambia have gone through a cycle of operations. Planning agencies were initially organized as separate agencies and were later brought under the aegis of a single ministry with finance, an arrangement found to be rather unwieldy. Without appropriate techniques of coordination, however, harmonious working could not be achieved. To some extent this was inevitable where the problem was perceived to be between two functions rather than building up a network of relations among different units that function within budgeting and planning. Further, some of these units developed a style of their own, irrespective of the formal organizational pattern of budgeting and planning. Aided by other political considerations, the integrated form was once again divided and planning and finance began to function separately. In each

31 Wildavsky (1969) wrote in terms of rescuing policy planning from the PPB trappings, pp. 833–64. Schick (1969) also reaches the same conclusion but for different reasons. To him, planning needs to be separate because budgeting involving routine takes place only during a specific part of the year and, on the whole, budgeteers are insulated from the outside world. Schick’s portrayal of the budgeteer is fortunately not typical (see “Systems for Analysis: PPB and its Alternatives,” pp. 817–34. Both papers are included in United States, The Analysis and Evaluation of Public Expenditures: The PPB System, Vol. 3.

32 A. W. Johnson (1959) warned that the integration of the agencies without developing requisite coordinating devices would have undesirable consequences (p. 153).
case, however, there were valid reasons in favor of either arrangement, although their contribution was limited where the problems were of policy rather than organizational.

IMPROVEMENTS

The above types of problems were recognized and efforts were made to solve them. Some of these improvements have been mentioned earlier and the present state of planning reflects this evolutionary growth. The impact of the improvements may not always be evident, however, either because they were slow in coming, because of a change in the economic climate in the meantime, or because of both. The improvements and approaches recognized that if a harmonious relationship were to be achieved both budgeting and planning needed change. This recognition itself is a significant one, for it implied that the bitter debate as to who was responsible was over. The improvements may be analyzed as those that are organizational and those that are technical inputs.

Organizationally, a major effort was made in a number of countries to improve coordination at the processing and working levels. At the processing level, the linkages between macroeconomic analysis, sectoral planning, and budgeting were recognized and procedures established to coordinate them. At the working level, joint teams, comprising representatives of finance, planning, and the spending agency, were also set up. In order to facilitate the budget linkages, improved classification on a uniform basis for the plan, budget, and accounts was introduced. (Considerable progress on this was made in India and Korea.)

In terms of technical inputs, the use of improved techniques of sectoral planning and their utilization has increased. Greater emphasis on sectoral planning has provided opportunities for disaggregating the national plan in detail and permitted working more directly with the ministries and agencies and improved the involvement of managerial levels in the formulation and implementation of plans. Similarly, improved annual planning has facilitated the building up of rapport with the annual budget. Efforts have also been made to improve budget programming for each major project included in the budget. As an integral part of this effort, calculations are made of the exact timetable of expenditure for subsequent years and of its annual effect.
on the operational budget. These improvements are modest and the dimensions of the remaining tasks to be fulfilled come into bolder relief when it is recognized that few countries have been able to achieve all-round progress in the above areas. As a report of the United Nations emphasized, "the results in most cases left much to be desired, for a variety of reasons."\textsuperscript{33} The continuing tasks of government financial management make it imperative that more attention be devoted to these areas.

Expenditure Planning and Forecasting

Although the introduction of new forms of budgeting or the adaptation of old forms for new purposes can be achieved, at least in theory, in spectacular jumps, this is best seen as an evolutionary process. One form which has evolved over the years and has attracted both proponents and opponents is expenditure planning and forecasting. Development planning, as noted in the previous chapter, was the framework chosen by the developing world for expenditures to further the objectives of economic growth. The industrial countries, with the major exception of France, adopted systems of expenditure planning and forecasting in the context of growth in expenditures and frequent resort to strategies that in the long run proved to be unsettling. There was, therefore, a search for stability of expenditure over a number of years and for assessment of expenditures in terms of prospective resources and in terms of the implications for the economy. As these objectives were translated into operational tasks, governments had to plan their expenditure strategy as a part of their medium-term economic policy, assess the effect on demand and resource use of individual programs, and look for methods in which expenditures could be used for the growth and management of the economy.

Expenditure planning and forecasting are inevitably intertwined. Planning implies the formulation of the goals and policies, while forecasting is a prediction of the future. Forecasting does not automatically produce a plan, but the process of forecasting provides an opportunity for decision making. Forecasts are sometimes more
than mechanical projections, as they reflect a design. Both planning and forecasting, therefore, are parts of the budget and generally take the form of rule-of-thumb projections. During the 1960s and 1970s, however, these two elements became a part of the formal budget process and are now used in a number of industrial countries (Australia, the Federal Republic of Germany, the Netherlands, New Zealand, the United Kingdom, and the United States), while others are initiating efforts to introduce them (Canada, for example). Planning and forecasting have also gained popularity in some parts of the developing world (Kenya, Malawi, Papua New Guinea, and Tanzania) and supplement the development plans.

Expenditure planning, whether undertaken as part of a development plan or as a separate but integral part of the budgetary process, is concerned with the purposes of expenditures, the appropriate rate of growth or decline of expenditures, the implications for the economy and for resource mobilization, and allocations to the sectors that are in need or, alternatively, reductions in expenditures to sectors that can continue with reduced allocations. The distinction between a development plan and formal expenditure planning is that the former represents an organized look into the future taken at a particular time, while the latter is a continuous process of making a forecast and assessing its validity as further progress is made in its implementation. In the development plan, the annual budget provides a corrective. Expenditure plans, however, form the basis for the annual budget and therefore represent updated annual elements of the development plan. Another distinction also merits recognition. Development plans may often be confined, insofar as government outlays are concerned, to new outlays, and may cover the ongoing outlays in broad aggregates. The expenditure plan is more specific and is coterminous with the budget; it includes continuing and new outlays. Expenditure plans are, therefore, continuous, disaggregated, and direct functional inputs into the budget. As such plans are to be viewed as budgets for the next few years, expenditure planning is also described as "multiyear budget planning" or "advance budgeting." This chapter considers the features of these systems and their technical and operational problems.

**Need for Expenditure Planning**

Expenditure planning, at either the aggregate or the detailed level, is based on an analysis and assessment of the factors affecting each
sector and an attempt to quantify those factors. It involves a three-step process. First, the underlying factors contributing to expenditure increases or reductions need to be defined, identified, measured, and forecast; second, an assessment of the standards of service required, or objectives to be met, needs to be undertaken, and third, the costs of providing services and the time profile of those costs for use in budget formulation must be computed.

These tasks, however, are no different from the usual budgetary tasks. The additional dimension for expenditure planning is forecasting the three-step process over a number of years. Even this dimension has a checkered record in the history of budgeting. One of the earliest budget forecasts over a period of years was undertaken in the United States in 1946, but it did not receive much attention, largely because of the technical problems inherent in any forecasting exercise. By the early 1960s, however, several changes in the nature and magnitude of expenditures led to fresh consideration of the need for systematic expenditure planning. Although other attempts were made at undertaking expenditure forecasts, the need for them to become an integral part of the budget process was specifically recognized by the Plowden Committee in the United Kingdom. As much of the impetus for expenditure planning came from this report, it is appropriate to consider here its background and the implications of its recommendations.

The concerns reflected by the Plowden Committee were at that time basically the same as those of the Government, as well as those of the community. From a philosophical standpoint, the major issue was management of the economy with specific reference to the resources of the community, the overall allocation of resources between the public and private sectors and the impact on the balance of payments, rate of price increases, and employment. It was justly felt that private sector operations came to be decided more in terms of a legatee than as a part of a deliberately conceived plan of action. There was also the view that the efficiency of the administration and management of public

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1 Occasional forecasts of government expenditures have been undertaken by economists. Specific mention should be made of Otto Eckstein (1959), and Gerhard Colm and Peter Wagner (1966). Similar attempts were made in the reports of a symposium, Public Finances: Need, Sources and Utilization (New Jersey: Princeton University Press, 1961).
2 United Kingdom, Control of Public Expenditure (1961).
services, as well as the evaluation of ongoing and new policies, could be greatly improved. Although some efforts were made to strengthen the budgetary mechanisms by improved costing methods, it was recognized that the budgetary process at a technical level also had large gaps. For example, the responsibility for decision on the totality of public expenditure was divided between central or local governments and nationalized industries. There were a large number of decision makers, whose concerns were not always properly captured by the budget coverage and the budgetary process. Decisions were being taken in a piecemeal way, without attention to the linkages with other areas of expenditures or without full awareness of the implications for future resources. The time scale of the fiscal year, within the range of which decisions were taken, was too short in a number of sectors relative to the sizable outlays that were spread over a number of years. Adjustments could not be made in these outlays on an ad hoc basis. At the same time, needed adjustments could not be undertaken because a major part of the resources was already committed and adjustments in new policies require time before they are effective.\(^3\) At the departmental or spending agency level, the relationship between the demand for the growing services and outputs of the government, and the estimates of the demands of government departments was not given the recognition it warranted.

The reformers, in the form of the Plowden Committee, recognized the tendency of the Government to lose sight of future costs, of the long-term implications of short-term decisions, and of the formulation of tax policies to meet growing expenditures. They demanded, as a basis for action, that explicit and regular surveys of public expenditure be taken over a period of years. The reformers recognized the piecemeal and ad hoc nature of decisions, and they demanded that "decisions involving substantial future expenditure should be taken in the light of these surveys." Recognizing the economic and resource limitations,

\(^{3}\)There is considerable official and other literature on the U.K. experience. In the former category, specific mention may be made of Public Expenditure White Papers: *Handbook on Methodology* (1972a); *Public Expenditure: Planning and Control*, Cmd. 2915 (1966). *Public Expenditure: A New Presentation*, Cmd. 4017 (1969a); and "The Management of Public Expenditure" (1979b). All these are published by Her Majesty's Stationery Office, London. In the other literature, the following provide a historical and critical account: Sir Richard Clarke (1964); Sir Samuel Goldman (1973); Hugh Heclo and Aaron Wildavsky (1974); and Christopher Pollitt (1977), pp. 127–42.
they demanded that expenditures be viewed "in relation to prospective resources." The reformers also recognized the uncertainty of forecasting, over a period of years, and they sought to dispel some of the uncertainty by a continuous examination and re-examination of assumptions and a search for new and improved techniques. These approaches, the Plowden Committee felt, would "help the Government to make good decisions, by providing a better perspective. It will not provide automatic criteria, or create a substitute for the application of the judgment."\(^4\) The Committee intended these surveys for the internal use of government and doubted "whether any government will feel able to place these surveys before Parliament and the Public."\(^5\) The Plowden Committee's recommendations received support, and it was widely believed that the central problem of bringing the growth of expenditure under better control would be fulfilled through their implementation. The new system came to be known as the Public Expenditure Survey Committee (PESC), named after the group of officials who were entrusted with the task of making public expenditure surveys.

The factors implying the need for such public expenditure surveys have an acceptable universality about them. As the system came to be viewed as a viable framework for remedying some of the institutional problems, additional factors justifying the relevance of expenditure planning over a period of years came to be recognized. Such planning leads to improved decision making in specific ways that are recognized by those engaged in budget making more often than by the public. It provides a common base for weighing the cost of both new proposals and continuing policies, and it minimizes the element of "game playing" strategies. An additional factor proved attractive to the finance ministry—namely, that expenditure plans gave it a greater role. Expenditure plans are favored because they provide better policy inputs to central agencies without essentially reducing the operational freedom of spending departments. Most important is the inherent ability of expenditure plans to reflect the concerns of the government.


\(^5\) Notwithstanding this approach, pressures soon led to the public announcement of the U.K. Government's public expenditure plans—a tradition that is also continued and adopted in other countries. In Australia, however, expenditure plans are largely for internal purposes and are not published.
Expenditure planning and forecasting include the forecast of economic trends and of expenditures of government at various levels, the determination of the requirements of each agency, and the phasing of expenditures. As is true for the budgetary process depicted in Chapter 2, each of these aspects constitutes elements of the iterative process and each one leads to the next phase (Chart 4). Each of the elements depicted in Chart 4 reflects a group of complex activities, and their apparent simplicity is deceptive. The quantification of each aspect and the choices faced at each juncture give rise to several technical issues, not all of which lend themselves to quick, easy, or durable solutions. Before discussing the technical aspects of expenditure planning, it is appropriate to consider the nature of the forecasting and its general implications. In a way, forecasting is the Achilles heel of expenditure planning but, if properly done, it can lead to productive results. Lack of care or more emphasis on subjective aspects could make the forecasts questionable. From the technical point of view, forecasting budgets casts great responsibilities on the decision maker. Much of the accuracy of the forecast is dependent on his ability.

**Forecasting**

In day-to-day life everyone makes forecasts. In some cases, it may be just an intuitive guess, in others, it may be an organized projection based on available knowledge. Reliance may even be placed on the reading of the planetary configurations and their implications for individual or corporate fortunes. But it should be recognized that astrology is a science as well as a technique of forecasting. What gives importance to forecasting is that it is not treated as a single event but is the implicit normative basis for the projection—systematically exploring and selecting policy goals and alternatives so that the isolated events are incorporated into a decision-making process. In this form it has been used for weather forecasting and, since the advent of economic planning, for projecting future economic trends. Notwithstanding this application, the track record of forecasting has been rather problematic. Ascher notes "[a]ll the technological sophistication of our
Chart 4. Schematic Presentation of Expenditure Planning Process

1. Identification and determination of planning horizon
2. Macrolevel trends and related considerations of the economy
3. Formulation of the policy strategy for the planning horizon
4. Determination of the implications of existing and new policies
5. Determination of the price basis for the various components of expenditure
6. Determination of the requirements of each spending agency for the target period, and their phasing
7. Formulation of the annual budget and indication of the outlays
8. Monitoring of the implementation of the budget
9. Contingency budget for meeting unforeseen events
public and private sectors has not produced an enviable record of forecasting future problems and events.\footnote{William Ascher (1978), p. 1.}

In considering the nature of forecasting and its applicability, a distinction should be made between the use of forecasting in the corporate and the government sectors. In particular, three distinguishing features may be noted. First, the goals and operations of corporate planning (even of the multinational conglomerates) are relatively narrow, specific, and well defined. The corporate concerns are with product development and marketing, working generally under the assumption that the goal is to maximize profits. The goals of the government are far more complex, the process includes multiple levels of decision making, and generally the government is concerned with a vast range of goods and services that are not easily measured precisely. Second, decision making in government is largely political; while no organization can be totally devoid of it, politics are less significant in a corporate setting and may not have any immediate impact on the community. If a corporation leaves the market, another will enter, and the inconvenience to the consumer, if any, may be marginal or of short duration. The politics of government, however, extend far beyond the fortunes of a party and may have a lasting impact, in unpredictable ways, on the community. And, third, forecasting in corporations is a private and internal matter, and concerns over competition make it a secret operation. The forecasts of government are intended for public consumption, and the government is accountable not only for the technical accuracy of the plans but also for the results of the forecasts.

Forecasting in government has an added dilemma. Overoptimistic assumptions regarding economic performance lead to unrealistic estimates and thereby erode the credibility of the forecast itself. Specifically, in regard to expenditures, if these are tentatively fixed with reference to overoptimistic assumptions, their downward revision in the light of the changed economic situation becomes a problem that will soon degenerate into a political crisis. On the other hand, pessimistic assumptions are less palatable (although recent political experience suggests that such assumptions could, on occasion, be a strong asset for attaining power) and, in the sensitive financial area,
may prove to be a self-fulfilling prophecy.\(^7\) It should be recognized, however, that some of these aspects become more apparent on the basis of hindsight. The essential corrective of the forecasting system is that each forecast is not to be seen as immutable but rather as a flexible outline of future policies that must be revised in line with the changes in the economy and must be maintained on a “rolling” basis.

Forecasting in government can be unitary or can be an amalgam of components. The former is relevant when dealing with specific aggregates, such as the rate of growth of GNP and population. In expenditure planning, however, forecasting has a component-based approach. Since the attempt is to delineate the interrelationships between the economy and the budget—not as two broad entities but each as a total of significant blocks—forecasting has to be applied at a disaggregated level. Forecasting of expenditures has to facilitate the transition from the aggregates, which are the concern of the economic policymaker, to the details that are appropriately the responsibility of the program manager in the spending agencies. The forecast of the specifics is based on the forecast of the general trends in the economy, and to that extent, the former has to be an integral part of the latter. Forecasting in terms of the component-based approach should not, however, treat each portion separately, ignoring the linkages, but be more appropriately viewed as a holistic system that permits the detailed analysis of the interaction.

The validity of forecasting is partly dependent upon the remoteness of the target. The longer the period the greater is the possibility that conditions will change. Five-year projections may, therefore, be prone to greater error than the forecast for the next year. The choice of the appropriate period for expenditure planning presents another dilemma. The next fiscal year may be an ideal choice, purely because of the limited time between the forecast and the actual occurrence. But, as noted above, it may be too short to control the endogenous factors of expenditure growth. Also, in some respects, five-year forecasting

\(^7\)Ascher maintains that the importance of self-fulfilling forecasts has been exaggerated. While the decision makers do not control the pace of events involved, the fact remains that the public’s reactions and expectations play a crucial role in the success of financial policies. The announcements of government policies have significant effects in themselves (Ascher, 1978, p. 5).
periods may be considered to be too short. In view of the fact that projects take up to a decade from planning to completion, it might be expedient to forecast over periods that synchronize with the activities of government. Research development, major river valley projects, energy, retirement, and education policies are some aspects where periods that are considered appropriate for forecasting may prove too short for planning purposes. Part of this problem is, however, mitigated by the rolling nature of forecasting.

The success of forecasting and its utility to the policymaker are dependent on the comprehensiveness of its coverage and the accuracy of the estimates. The accuracy, in turn, is dependent on the objectivity that the policymaker is able to bring to the assessment of the economy, to the nature of its constraints, and to its operations. Even in the best of times, this is a hazardous area and clearly needs the best attention. In addition, if it is to prove acceptable to the participants, it should be based on a clear understanding of the general political considerations. It should, therefore, include the participation of the ministers and others who are engaged in the budgetary process.

**ECONOMIC OUTLOOK**

The several objectives of government fiscal policy are intertwined, and priorities need to be established. In arriving at choices, however, it is necessary to take into account the outlook for the economy and its implications for expenditure, as well as the autonomous factors contributing to the growth of expenditure and their impact on the economy. These are pursued in two different strands—one dealing with the formulation of the economic outlook, and another dealing with the expenditure requirements in future years. For administrative purposes, however, these strands interact and thus contribute to the formulation of fiscal policy.

The determination of the outlook for the economy involves the assessment of developments in the domestic and external economies, productivity, growth in the economy, the rate of inflation, developments in wage rates, and overall domestic demand and economic

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See, for example, the analysis of the U.S. Government on population change and long-range effects on the budget, which cover a decade or more, *U.S. Government Budget 1981*.
activity. Oil price increases or reductions and their impact on the economy would similarly need to be forecast. In countries that are highly dependent on exports, the demand for their domestic products needs to be assessed. Similarly, changing import prices and the future costs of external borrowing need to be identified. The purpose of this exercise in a narrower context is to ensure that the overall implications of fiscal policy in general, and expenditures in particular, are consistent with the macroeconomic plan of the economy. The projections for the economy would establish the broad framework within which to determine the policy guidelines of expenditure forecasts. Without this policy guidance, expenditure forecasts would potentially become shopping lists. By their very nature, however, projections for the economy may not be precise and need modification and if they are seriously in error, it is likely that the number of modifications in expenditures will be considerably greater.

Forecasting the outlook for the economy has reached a high degree of sophistication in recent years, with considerable reliance on economic modeling and related exercises. Briefly, however, the formulation of the economic outlook in the current context involves no sectarian view that is exclusively Keynesian or monetarist but often is a pragmatic combination of the two. Following the traditional approach, and after examining previous trends in the economy, judgment is made on the long-term growth potential and outlook in terms of the technological and demographic factors. This is then adjusted for cyclical changes in the economy. At the same time, an estimate is also made of the nominal rate of growth in GDP and there is an interface to reconcile the growth potential with financial constraints. In the light of that analysis GDP growth is formulated. The degree of sophistication involved in the identification and

9One of the more detailed macroeconomic models is the one utilized by the U.K. Treasury, which has more than 250 equations. For a discussion of these aspects, see United Kingdom, Treasury Macroeconomic Model: Equation and Variable Listing (1980c). Similarly, there is an impact program in Australia, which is devoted to the development of a medium-term to long-term, economywide, economic-demographic model. It is an integration of three modules: (i) MACRO, concerned with the fiscal and monetary aggregates; (ii) BACHUROO, which is a module designed to keep track of the evolving population and work force; and (iii) ORANI, which is an interindustry module. For a descriptive account of these models, see Report of the Royal Commission on Australian Government Administration, Vol. 4 (1976), Appendix, pp. 11–22.
measurement of the interrelationships will determine the practical relevance of the economic outlook.

The specification of the interrelationships and the publication of the outlook have gone through a period in which there was initial reluctance to publish them (in view of the pronounced announcement effects discussed earlier). Over time, however, there has been more willingness to publish them. In the United Kingdom, the publication of medium-term strategy is considered as an important element in the process. There is, however, considerable variation in the practices, and in the degree of detail, of those countries that have taken to expenditure planning and forecasting. In the United States, for example, the practice within Government has been to use economic goals, e.g., lower unemployment, as the basis for its five-year projections of revenue and expenditure. In the Federal Republic of Germany, the Financial Plan for the period 1979–83 is based on the assumption that annually the real growth of the economy would be 4 percent and increases in prices 3 percent. The projections of revenue and expenditure are made within this framework and fiscal policy guidelines, as in the United Kingdom, emphasize keeping the annual rate of growth of expenditure below the anticipated rate in the GNP. In the Netherlands, the future of the economy is stated in the Budget Memorandum and is based on the estimates of the Central Planning Bureau.

The outlook and the assessment of the economic trends is less detailed and more aggregate in developing countries. Specifically, in countries that have adopted expenditure forecasting, it appears that the forecast of the economy primarily relates to the rate of growth that is indicated more as a target than as a forecast.

10 In the United Kingdom economic forecasts are required to be published twice yearly under the Industry Act, 1975. The medium-term strategy is announced in the annual White Paper on Government Expenditure Plans.

11 In the United States this has been the practice of the Government. The Congressional Budget Office (CBO)—a branch of the legislature—however, presents two sets of projections assuming different rates of growth in the economy. The economic assumptions of CBO projections do not reflect the probable economic conditions of policy targets and are more illustrative in nature. The projections of the Office of Management and Budget could lead to higher surpluses because of the working of the fiscal drag.

12 Germany (1980), p. 2. Only an abridged English translation of the Plan is available.
ANATOMY OF EXPENDITURE PLANS

Formulation of the expenditure forecasts and determination of the related policy design require that their principal ingredients, such as the totality of expenditure, be clearly recognized in the system evolved for the purpose. The frame of reference of expenditure forecasts and the practices may conveniently be considered in terms of the coverage, period, content, and basis of the forecast, and the form of presentation of expenditure estimates. These aspects are considered below.

Coverage

The purpose of expenditure planning is to bring together the operations of those entities that have an impact on the economy regardless of legal and other differences in their operations. This indicates that, in addition to outlays by the central government, the expenditure plans should ideally include the transaction of other branches of government including public enterprises. Consideration of the totality of expenditures poses more problems in a federal arrangement than in a unitary form of government. Integrated plans are not obviously feasible in the classic federations such as Australia, Canada, India, and the United States in view of the specific constitutional rights of provinces and states for raising revenue and incurring expenditures. In countries such as the United Kingdom where no state governments exist, the grants and other capital expenditure to the local authorities are included in the expenditure plan. In the Federal Republic of Germany, state governments are obliged to formulate their own financial plans and coordinate with federal plans. In Tanzania, however, local governments have no revenue-raising powers and are dependent on the Central Government. As such, their transactions form part of the total expenditure plan.

Target period

Just as there are various ways of assessing the economy, or measuring the budget impact, there are also various periods for which forecasts can and are made. In some countries, the practices have varied over the years. For example, in the United Kingdom, the initial practice was to make the forecast for five years. However, as the estimates revealed a greater margin of error for the later years, a
transition was made to the "focus years," or the period in which the working of the policies could be envisaged with greater certainty. Under the procedures now in vogue, the U.K. expenditure plans provide estimates for three years in addition to the next fiscal year (3 + 1). A similar procedure is followed in Australia, New Zealand, and Kenya. In the United States the forecasts are divided into two groups: (1) a three-year framework in which budgetary decision making takes place, and (2) an additional two-year period containing the extrapolations of the budgetary effects of current policies. In the Federal Republic of Germany, forecasts are made for four years, in addition to the fiscal year (4 + 1). In Tanzania, however, they are made for only one year after the fiscal year for which the budget is presented; however, in the event, the period is too limited for making meaningful assessment of the policy directions and related adjustments. Although the choice of the period is influenced partly by administrative convenience and partly by actual use of the forecasts for budget policies, it appears advantageous that the period should be longer than two years. On the basis of experience, three years seem more popular.

Content of expenditure plans

A feature distinguishing expenditure plans from development plans is that the latter are usually structured to deal with new outlays rather than with existing policies. Expenditure plans, however, involve the future implications of the existing policies as well as new outlays. In terms of the PESC practices in the United Kingdom, outlays on existing policies and new services are dealt with in a pragmatic way. Ideally, expenditure forecasts could be formulated to show (a) the present level of expenditure, (b) additional expenditure to provide the same service in future, for example, to maintain a pupil/teacher ratio in educational institutions, and (c) additional expenditure if the service is to be changed. Elements (a) and (b) can be described as existing policy, while (c) can be defined as new policy. In reality, however, the distinctions between existing and new policies may not be clear and may be blurred depending on the nature of the sector and the statistical data available. From the point of view of spending ministries, changes in the policies may not always imply radical departures from the existing ones and are, at best, minor modifications to prevent what the
ministries perceive to be a deterioration in the services. Moreover, for many activities of government the type of objective tests of requirements or of measurement of productivity may not be available. Further, the development of such information presupposes the existence of a performance budgeting system. The practice in the United Kingdom is that for each year of forecast the previous year's level of service is taken as the base, this is then modified by additions representing new policies and subtractions reflecting the closure of activities that have already been agreed to during the year. Proposals over and above the levels so indicated constitute new policy proposals. This procedure implies that forecasts become effectively the annual budgets. In other countries, particularly in the United States, the eventual budget is made by the legislature and forecasts of government are illustrative of the policy implications. In the U.K. system, division of expenditures into existing and new outlays provides a firm basis for the decision maker, particularly at the ministerial level, to take a view on the programs as well as on the aggregate. If a trade-off is to be made between the existing and new outlays within specified resources, the implications will be clear to the decision maker. In the developing countries forecasting is done at a more aggregate level and basically involves the application of percentage growth rates to existing and new outlays. A technical issue that could often contribute to divergence between the content of the expenditure plans and the actual spending is the use of different bases. For example, in the United States, planning is done in terms of the obligational authority but the outlays are not controlled by it. Although certain stable relationships between authority and actual spending are assumed, misjudgment of exact timing could, and does, lead to significant divergences between the forecast and the actual amount of spending. Congruence between these two is essential for the success of the forecast.

**Price basis**

One of the major problems encountered in formulating expenditure forecasts is the choice of the proper price basis. The essence of medium-term forecasting and allocation of resources is to ensure that the decisions involving commitments of economic resources for the future are taken according to a rational pattern of priorities. Planning, therefore, involves the measurement of the cost of services in real and
monetary terms, as well as the value of resources in terms of the relative claims on GDP. Formulation of expenditure estimates over time involves the choice of using constant or current prices. As the approach of the Plowden Committee emphasized, the establishment and attainment of real expenditure targets both by each functional category and by total meant that forecasts had to be analyzed in terms of the relation of the expenditure targets to the projected growth in physical resources as measured by GDP at constant prices. But the approach of constant prices had several conceptual and operational implications that could not be ignored and if constant prices were chosen, compensating devices had to be utilized.

The choice between constant and current prices is not in any event an easy one. The United Kingdom, which pioneered the expenditure forecasting system, resorted to constant prices in its price surveys, while other countries utilized current prices for formulating their forecasts. The adoption of constant prices had, however, been continually riddled with problems, and after approximately two decades of use these have recently been abandoned by the U.K. authorities. The experience with constant prices fully illustrates the complexity of problems involved in the choice and it is, therefore, instructive to deal with the experience of the United Kingdom in some detail.

Constant prices

The use of constant prices gives rise to difficulty in comparing actual expenditures (which are in current terms) with the provisions shown in the forecasts. It also obscures the real factors contributing to increases in costs. This was particularly true in respect of cost increases caused by increases in the salaries of government employees, which, in terms of the national accounting conventions, are not accompanied by any increase in productivity. The increase in the costs of services caused by pay increases are as important as those caused by expansion of public services, and anomalies of public policies may arise when one is differently treated from others. Moreover, the constant price

13 These problems were recognized by the U.K. Government. See United Kingdom, Public Expenditure: Planning and Control (1966), p. 12. See also United Kingdom, Public Expenditure: A New Presentation (1969a), pp. 22-23.
presentation will constantly underestimate the future weight of public services in relation to the economy as a whole because of the zero productivity convention. If salaries of government employees increase at the same rate as those in the private sector, it will mean that the cost of providing the services rises more than the average prices for the economy. This, however, is not captured in constant prices and, if undue reliance is placed on that approach, the actual experience may turn out to be vastly different from that estimated. It could also mean that, if constant prices are to be trusted, the community is either getting increased and better services or, alternatively, the same services are provided by fewer staff. More significantly, by underestimating the cost, the opportunity cost of the use of resources is not fully revealed. In the narrower context of budgeting, estimates in real and constant terms imply that cash has to be provided, regardless of the price rise, in order to maintain the agreed levels of services in real terms. This had the potential of depriving the government of control over cash expenditure exactly when it needs this most.

In practical terms, in the United Kingdom the forecast of expenditure was given in volume terms or in constant prices. Under the practices in vogue until the early 1980s, the base dates for constant prices varied. For most expenditures on goods and services constant prices were those that obtained in the last year. For computing transfer expenditures, the average of the current year's prices was used as a basis. However, because the use of constant prices did not fully reveal the value of the services, and reflected not the quantity of services produced but the quantity of manpower and other resources that were used in supplying those services, the concept of relative price effect was used. The term refers to the change in the prices of goods and services bought by government relative to the average price of national output and measures the extent to which the resource used by the public sector becomes more or less valuable than those used in the national economy. In short, the relative price effect is the difference between the estimate in current cost terms and in volume or constant terms. In

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14 This was foreseen by Enoch Powell. See extracts from his letter in David Galloway (1976), pp. 154–55.
15 Volume term connotes that physical yardsticks are used for measuring the services and their requirements. In practice, however, this has not been possible for a large area of government and constant prices have been used instead.
addition to the forecast made on the above basis, the plans also provided for a contingency reserve to cover requirements for increased expenditures that were not foreseen or that could not be properly quantified. The amount so set apart varied depending on the uncertainty.

The configuration of prices, therefore, included three approaches: (a) in constant and volume terms, (b) in cost terms, including the operation of the relative price effect, and (c) in outturn prices or current prices in terms of which the actual expenditures were incurred. The use of this three-tier structure, and the problems inherent in making an accurate forecast, contributed to annoying issues that became more prominent after 1973. Those that merit consideration are the implications of the three-tier price structure, the computation of the relative price effect, and the fear of the loss of financial control. The use of three different prices obviously generated considerable confusion among the spending agencies. Expenditures in constant prices were not the ones in which payments were made, nor did they represent the figures recorded by the accountants. Comparing ongoing expenses with those of previous years was not meaningful, unless they were deflated and made uniform—an aspect in which the lay administrator did not feel proficient. Nor did this give to the public any better perception of the role of public sector. At the same time, the revaluation of outlays that had to be undertaken at the end of the year caused additional burdens. The impact of the new language of constant prices can be seen by the epithet given to them—funny money—or money in which no transactions were carried out but which was used for policy purposes. While the severity of the problem may have been reduced over the years, there is no gainsaying that it contributed to a language interpreted by participants—each in his own way—with no common wavelength.

Estimating the relative price effect is also difficult. After the general price increase of 1973 and reflecting some speculative activities, the prices of land and houses moved very sharply upward, and the catching up in the pay awards for civil servants contributed to higher

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16See Maurice Wright (1979), pp. 143-69; and R. W. R. Price (1979), pp. 68-76. The measurement of the actual impact of the relative price effect requires detailed calculations and is not obvious from the White Papers which show only a total figure for public expenditure as a whole.

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expenditures. These factors, associated with others, in particular the rate of inflation, contributed to expenditures that were substantially higher than those shown in expenditure forecasts, in turn, implying that the price effect was not fully estimated. This rising discrepancy between the cool rationalism of the expenditure White Papers and the more sordid actual expenditures cast aspersions on the efficiency of the expenditure control mechanism. Some felt that in paying more attention to planning expenditures, the use of conventional financial control had been relegated to the background, leading to more expenditures than planned. The Expenditure Committee also reported "we feel bound to conclude . . . the Treasury's present methods of controlling public expenditure are inadequate in the sense that money can be spent on a scale which was not contemplated when the relevant policies were decided upon." The Chancellor of the Exchequer himself felt that the time had come "to reflect seriously on the wisdom of planning public expenditure solely on the basis of constant prices." Another Chancellor admitted, albeit half a decade later "there is something inherently unreal in trying to plan and measure things in terms of what is rightly described as 'funny money'." The recognition of the problem did not lead to any immediate changes in the basis, but a compensating device known as cash limits (discussed in the following chapter) was introduced to contain expenditures.

The dangers of formulating expenditure plans in constant terms has persisted and there has been growing disillusionment. The final break from constant terms was announced in 1981 and is operational from fiscal year 1982/83. Announcing this change, the Chancellor stated that the examination of expenditures would be conducted in terms of cash (in current prices) that would be available for that year. It was recognized that the new system could be difficult for those in the spending agencies who will be obliged "from the outset to form a view as to what their money will buy." This change involving the use of

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17 See Wayne Godley (1976).
18 United Kingdom, The Financing of Public Expenditure (1975b), pp. VI–VII.
21 The Chancellor observed: "This is bound to be less easy than just deciding what they want—and then simply looking forward to receiving all the money necessary to pay for it," Budget Speech, ibid. The new arrangements also envisage a change in the

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current prices or “money of the day” implies a substantial modification of the PESC system but is in line with the broad evolution of the control and administration of public spending since the mid-1970s. The procedures relating to the use of prices in current or cash terms are yet to acquire extended experience and their success depends on the care taken to project future prices. (This aspect is considered in the following chapter.) For example, in the Federal Republic of Germany, there are three types of expenditure in the formulation of the plan: (a) expenditure on wages and salaries that take into account future increases; (b) index-linked social expenditures that are based on future price rises; and (c) other expenditures that also allow for future price increases. The financial plan itself is expressed in terms of expected prices. The Netherlands has a similar practice, in which expenditure plans are expressed in outturn prices. In two developing countries in Africa (Kenya and Tanzania) estimates are expressed in outturn prices but, in computing them, it is expected that the rate of expenditure growth stipulated for various programs will also include the rate of price increase.

The difficulties of choosing the proper technique and of making it credible over a period illustrate the strengths and weaknesses of an expenditure forecasting system and the reason for its relatively slow growth and spread.

Form of presentation

The form in which expenditure plans are formulated and presented should, as far as possible, be close to the budget categories. Without such congruence, there will be problems of coordination. Also, if expenditures are to be monitored and controlled in terms of the plans, then they have to be essentially the same as the budget groups. In recognition of this obvious need, the U.K. authorities have made improvements both in plans and budgets and now the same functional, economic, and spending authority groupings are used by them. In the Federal Republic of Germany relatively broad groupings are used for use of the contingency reserve, which hereafter will be also used for meeting unforeseen price increases. These changes, which have some presentational and administrative convenience have also been criticized on the count that undue reliance on cash or current prices may lead to neglect of volume and output aspects.
financial plans and detailed categories are used in the budget. In developing countries, the categories reflect primarily the spending authority groupings and the forecasts are very broad and lack detail. Budgets, however, are more detailed, necessarily so for the purpose of obtaining appropriation authority.

**INSTITUTIONAL ASPECTS**

In order to be effective, the expenditure planning and forecasting system has to become a part of the annual budget cycle. This fusion has been attained in the United Kingdom. The cycle of operations, like that of the budget takes approximately a year. At the end of each calendar year instructions are issued by the U.K. Treasury regarding the procedures of the expenditure survey to the spending agencies, which then furnish the relevant information and estimates by the end of February. The estimates are then discussed by the Treasury and the spending departments and agreement is reached over two months. A draft report is then prepared by the Treasury and, after approval by the Public Expenditure Survey Committee, is submitted by midyear to ministers, who then take decisions on the aggregate as well as on the composition of public expenditures. The estimates are then published. Three aspects of these procedures merit particular attention. First, formal consultative machinery has evolved for decision making on public expenditures. The proposals for expenditure increases and reductions, and the assessment of their costing, are reviewed by the Principal Finance Officers, who work primarily as a part of the administrative department but represent, as it were, the financial conscience of the Treasury. These Finance Officers represent an inner Public Expenditure Survey Committee and their approaches have a decisive influence on the final outcome. The approval by the Survey Committee is more formal, and during recent years its deliberations have not taken more than an hour. The growth of the consultative machinery has been largely instrumental in providing a degree of stability to the process and in reducing the distrust that spending agencies traditionally have toward finance ministries. Second, the involvement of ministers has added the requisite political dimensions to the process. Third, the surveys so made reflect not merely multiyear planning but, for the following year and some of the focus years, multiyear budgeting as well. Similar but less formal procedures are
observed in the Federal Republic of Germany. A new financial plan is prepared each year, together with the Government's draft budget, and is then finalized by the Finance Ministry in close cooperation with expenditure departments. After approval by the Cabinet the plan is presented to the legislature for information. Australia and New Zealand have installed procedures that are closely modeled on the practices of the United Kingdom. In the United States the system is used primarily as a management tool to ensure that the long-term consequences of present policies are identified and recognized in the budgetary decision-making process. In the few developing countries where the system is prevalent in one form or another, it appears that there is neither formal consultative machinery nor any attempt to integrate the forecasting system with the budget cycle. The spending departments are asked to furnish proposals but these are substantially changed by the planning agencies (in Kenya and Tanzania the forward budgets are organized by the planning branches of the finance ministries) and the final estimates are shown only in the aggregate.

COUNTRY EXPERIENCES

The experience of expenditure planning and forecasting systems, as has been repeatedly pointed out above, is restricted to a few countries. The longest experience is that of the United Kingdom, which initiated the experiment in the early 1960s. The last two decades have revealed attitudes of probing, strengthening, further probing, and undertaking necessary adjustments. There was a willingness to change, although the process of change itself took time and, on the whole, the system showed greater resilience and responsiveness. Although the beginning was hesitant, more arduous tasks in specifying the outlook for the economy were undertaken. The system itself was buffered during 1965–68 by economic crosscurrents and was caught between the optimistic assessments of the economy, on the one hand, and the necessity to control expenditures in the context of a gloomier economy, on the other. The developments in the mid-1970s proved conclusively the difficulties in the use of constant prices and the correct calculation of the relative price effect. While these aspects may lead to the opinion

22 In New Zealand, the Public Expenditure Survey Committee is known as the Committee of Public Officials for Public Expenditure (COPE).
that there is no simple way in which forecasts can be made, it also
illustrates that more faith than warranted may have been placed on the
forecasting techniques.

The German experience, which started in 1967, has had relatively
more stability and coherence. This may be due partly to the dread that
the Federal Republic has for budget deficits and, therefore, the general
readiness to ensure containable growth rates in expenditure, and partly
to the state of the economy itself. Australia and New Zealand
established the system of expenditure planning and forecasting, and
installed sophisticated information systems for keeping track of value
and price changes. Progress in both countries is considerable and the
preparation of expenditure forecasts has become a part of budget
folkslore.

The experience of the United States reveals a different dimension
and illustrates the difficulties inherent in an environment in which
planning is considered in emotional terms and as an anathema.
Notwithstanding the occasional projections of expenditure at the
federal level from 1945 to 1961, the real impetus for medium-range or
long-range expenditure planning came into formal existence only as a
part of the program budgeting introduced in the Department of
Defense after 1961. This was later extended to the whole Federal
Government as part of the Planning, Programming, Budgeting
System (PPBS). One of its major features was "projection of govern­
ment activities over an adequate horizon." The formal shape for this
was given as program and financial plans (PFPs), under which the
spending agencies were required to provide a multiyear summary of
the programs over a planning period covering the budget year and four
future years or over longer periods wherever considered essential.23
But the implementation of this aspect, as with others, revealed several
difficulties, all of which owe their origin to the lack of an adequate
theory of requirements.24 In the preliminary stages of the implementa­
tion of the PPBS, no specific direction was given to spending agencies
on how expenditure planning for future years was to be done. They
were merely asked to indicate how much and in what way they would
spend money in the future. The results of the approach were
predictable; there were lengthy "wish" lists of what the agencies would

like to spend on their programs if no fiscal constraints were observed.  

The idea that the computation of future cost implications of current decisions would drive the "thin edge of the budget wedge" into the program did not materialize. Later, the scope of the PFP was changed to include only those outlays to which the Government was committed by legal or moral (emphasis added) obligations resulting from past decisions or required by current decisions. The definition of the "commitment" lacked precision and agencies tended to use different definitions and resource limitations. If at earlier stages lack of guidance contributed to problems, it was lack of specificity that compounded these problems at later stages. The exercise itself has not been without benefits for it clearly enabled many agencies, depending on the competence of their internal financial management, to gain perspectives on funding requirements in the future. But the submission of PFPs by agencies was quietly dropped and is no longer required as a part of the budget process.

These practices were reviewed in 1977, as a part of the Zero-Base Budgeting (ZBB) system. The instructions relating to the introduction of ZBB specified that the resource requirements for four years beyond the budget year were to be submitted along with other materials.  

Another development was that the legislature required a five-year projection for mandatory or entitlement outlays. During the 1960s and most of the 1970s, the agencies gained much experience in undertaking future-year expenditure planning, but for several years these were primarily internal or selective exercises that were generally in the nature of projections. Multiyear advance expenditure planning became an integral part of the budget process only in 1979 and the Government’s planning horizon was formerly extended to three years, with projections for another two years, all of which are published as part of the budget documentation. The actual impact of these developments is still to be felt.

APPRAISAL

The experience is both limited but paradoxically adequate to reveal the practical benefits and problems of the system. It is limited because


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it is primarily the experience of selected industrial countries that offers us the relevant evidence. But it is adequate because the experience extends beyond a decade. To consider the benefits first, it forces the agencies, the public, and the legislature to consider the future implications of current decisions and their impact on the economy. It affords an opportunity to consider the national initiatives in a broader setting and in a phased way, thus minimizing the need for abrupt movements. Within the Government, it changes the value structure that has dominated budgetary thinking and financial controls for more than a century. The explicit and institutionalized (as distinct from ad hoc) consideration of the economy helps to form a clearer policy and, more significantly, the holistic approach of bringing diverse elements together permits a better recognition of the linkages. The planning system is not a single cosmic operation but can serve the complex requirements of current economic management better than the traditional systems. Each year the past as well as the future can be reviewed and this constant monitoring offers a substantial degree of flexibility.

But these very benefits, depending on the skills with which they are used, could, and indeed have, become problems, which may be examined in terms of those relating to the preparation of spending plans in conjunction with prospective resources, in forecasting techniques, and in the implications of the system for expenditure control. The experience described above suggests that the specification of the future of the economy has been a matter of primary concern. Given this uncertainty, formulation of spending plans contributed to a planning paradox that, if the actual growth of GNP were less than forecast and assuming that expenditures were proceeding as forecast, a higher ratio of expenditures to GNP would emerge.\(^27\) There are also factors that do not lend themselves to any meaningful forecast, such as natural disasters. It is also evident that some of the national accounting techniques (e.g., constant prices) have contributed to avoidable problems and clearly illustrate the limitations of economic principles

\(^{27}\) By 1979 prevention of this phenomenon became a major government objective. The U.K. authorities noted “To plan more public expenditure before the required output is available to support it would ensure that, in the event, that growth of output does not take place. Higher public expenditure cannot any longer be allowed to precede, and thus prevent, growth in the private sector,” United Kingdom. The Government’s Expenditure Plans, 1980–81 (1979a), p. 2.
in governmental policymaking. Over the years this has led to considerable skepticism and to the claim by political scientists that some of these approaches may not provide for a viable public decision making. The alternatives for this clearly cannot be decision making by faith or on an ad hoc basis, but must be by assiduous efforts at improving the system. Indeed, viewed over the long term, some of these may be considered as problems of the initial or trial period.

The implications for control are more diversified. The critics of the system argue that expenditures once included in the plan become a "right" for the spending departments and a commitment on the part of the government. So considered, the existing policies will become sacrosanct, will resist innovation, and may create a bias for perpetuation. Also, in considering the new policy prospects, the spending departments may try to "beat the system" by having proposals considered outside the normal expenditure planning system. Admittedly, if forecasts are considered as firm commitments by government, the system is liable to break down sooner or later. Although pressures, both internal and external, will develop for the continuation of policies, it is only appropriate that estimates be considered as forecasts and not definitive financial plans.

Another problem that is rather pronounced in the United Kingdom is in regard to the phasing of expenditure. The experience suggests that there is a bow-wave in expenditures implying higher expenditures for the immediate fiscal year and tapering outlays for future years. Cynically known as "fairy gold" it implies that the spending departments trade cuts in future years in order to maintain the present amounts. Also, in some countries, the implicit pact between the spending departments and the central agencies was not maintained and there were spurts in expenditures. This implies the need for strengthening the expenditure control mechanism, in particular, the need for detailed review of the estimate bases. A fundamental weakness of the system is that it is based only on inputs and does not emphasize

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29Such bow-wave phenomenon is not evident in the German financial plans. The experience of developing countries shows a reversal of the bow-wave by the fact that expenditures increase gradually and are sizable in the later years of the plan.
30Ireland gave up advance expenditure planning when the spending departments did not comply with the resource limitations.
the outputs. It also provides information on existing policies but does not consider alternative policies. Although part of the problem is reduced by undertaking separate policy reviews, it is important to relate the results of such studies to the budget process.

The system requires skills different from those that are found in traditional bureaucracies and it demands the provision of varied information related to expenditure plans, in particular, information on the costing of projects and programs. The slow progress in this area has been a reason for the system not making much headway in developing countries. Even where it has been initiated in some countries, because of a lack of information and of explicit commitment or attention by policymakers, it remained more as a supplemental instrument to the traditional machinery.\(^\text{31}\) There is more to be done if this system is to become a regular instrument of government financial management.

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\(^{31}\) In India, when rolling expenditure planning was tried to be introduced in 1979, it was viewed as an attempt not to strengthen the five-year plans but to replace them. It, therefore, never became operational, except that future outlays on major projects are shown in performance budget documents.
Inflation became a worldwide phenomenon during the late 1970s. If, during the 1950s and 1960s, the problem was experienced by a few countries in Latin America and Asia, inflation became more rampant and chronic and persisted at high rates during the 1970s in a variety of countries. Some expect that the trend will continue during most of the 1980s. Others predict that there will be a massive downturn and that the problem faced by policymakers will be, not inflation, but a deepening recession, and that concern will be on the ways in which the downturn could be avoided. While the prognosis differs, the need for the study of inflation itself requires hardly any defense.

The effects of inflation are far-reaching and affect all aspects of budgeting with varying degrees of severity. If budgeting is to serve the central policy function as it has done during the last three decades, it is essential that the impact of inflation on the budget, as well as the impact of the budget on inflation, are recognized and analyzed in the proper perspective. To the extent that these aspects are not given proper consideration, the budget is formulated on suspect premises and may reflect a wrong reading of signals, as well as giving inappropriate signals to the economy. In several countries, the lack of recognition of inflation may contribute to the worsening of the government’s fiscal situation as its slowness to react to taxation and to introduce tariff changes may cause reduced revenues, which, with increasing expenditures, will lead to higher deficits. Although these aspects are felt and experienced by every policymaker, little attention
has been given to this aspect in the literature. A good deal of the available literature deals with the individual's expectation and his behavior in an inflationary environment. Government, admittedly different from an individual in its approaches, received scant attention. Ironically, during recent years and as is evident from the burgeoning literature, considerable attention has been devoted to inflation accounting, largely because of increased tax liability being a concomitant of inflation. The concerns of the budgeteer are, however, real and have grown in their importance along with the persistence of inflation.

Every budget is formulated, either explicitly or implicitly, on a price basis. As prices rise and become relatively unpredictable, the problems of budgeting are felt more keenly. With inflation, one year may appear too long a period to keep costs and budgets the same. Inflation budgeting implies a correct reckoning of current and prospective prices—the prices at the time of the budget formulation and the changes in prices after the budget becomes operational. The greater the rapidity of changes in prices, the greater are the problems encountered in policymaking and for the budget in fulfilling its economic role. What is the nature of inflation? How does it affect the budget? What are the current approaches toward these issues? What are the policy options when the rapidity of price change is greater than estimated? Should the rate of inflation be forecast? What are its implications? How can a budget be formulated to reflect the realities of inflation? Is indexation a partial or complete answer to these issues? What are the implications of inflation for program management? These are only some of the questions that need to be answered. This chapter and the following one consider these issues. This chapter deals with the more general issues of inflation budgeting, while the following chapter is devoted to the role of expenditures in economic management. These chapters do not seek to offer any settled conclusions or guidance on how specific aspects of the budget are to be formulated, but are concerned with a delineation of the issues and a discussion of the state of the art.

INFLATION: CAUSES AND NATURE

Inflation as a phenomenon is experienced by all members of the community. Some benefited by it but most are affected adversely. While the general perceptions about inflation are fairly common, the
factors contributing to it vary. These factors come in various forms and differ in their incidence from economy to economy. However, five factors are enumerated here as those contributing to inflation. First, the pursuit of expansionary fiscal policies by the government has led to higher deficits, easy money policies, and greater liquidity. The commitments to achieve full employment in the western industrial democracies and to use inflation as a source of finance for development plans in developing countries are frequently cited as major contributions to expansionary fiscal policies. Second, either because of the expansionary fiscal policies or because of generous credit facilities to the private sector or a combination of both, there has been an increase in the money supply in the economy and much of the easy liquidity is to be ascribed to the monetary policies of the central banks. Third, economies have been overheated, reflecting specific events of social disturbances such as wars. In industrial countries such overheating occurs when industrial capacity is fully utilized and employment is high and when increased demand causes prices to rise. In developing countries, short-term price increases may take place, not because of full utilization of capacity but because of a sudden drop in crop outturns and consequent commodity shortages. Fourth, there has been a gradual disappearance of money illusion causing wage earners to demand and receive compensatory increases in money incomes to offset actual and anticipated price increases. As a result, wages have risen faster than productivity, pushing up unit costs and leading to price increases. This sets in motion a new chain of activity of wages chasing prices in a spiral and contributing to ongoing inflation. Fifth, the general increases in oil prices since 1973 have changed the supply side and have generally added to the costs. In addition to these factors, it is also suggested that the large balance of payments deficits of the United States through most of the 1960s and the growth of international credit from commercial banking institutions has provided further stimulus to the growth of inflationary pressures in world economy. Depending on the choice of factors, solutions have also been suggested. The fiscal deficit theorists believe that inflation can be cured by balancing the budget and reducing the deficit. The monetary school adherents suggest that controlling the aggregate money supply would be equally effective. Those who subscribe to the overheating theory suggest that as soon as the heat disappears and as demand returns to normal inflation will be reduced; it is believed that a better
distribution system will be helpful in reducing commodity shortages. Others argue for tightly implemented wage and incomes policies. However, as wage and incomes policies have not been successful, and as mandatory controls leave much to be desired, emphasis may be placed on a combination of incentives and voluntary action and, therefore, some economists defend tax-based incomes policies. More pragmatic and conventional policymakers prefer a combination of fiscal and monetary policies to fight inflation. The diversity in approaches and solutions is not surprising, given the multidimensional character of inflation. It is evident that inflation is not a one-cause/one-solution problem but is many faceted and requires more organized efforts.

The necessity to fight inflation hardly requires any emphasis in view of the undesirable results that arise from high rates of inflation over prolonged periods. Four effects are easily identifiable. First, as liquidity increases and prices rise, there is a distinct possibility that exports will be discouraged or imports will be encouraged, thus contributing to greater problems for the balance of payments. The experience of the industrial and developing countries conclusively illustrates that strong inflation leads to capital flight, an increased demand for imports, and reduced exports. In due course, pressures will be exerted on the exchange rate and frequent changes in the rate could add to the supply costs of certain commodities. More important, this will lead to the search for financial resources to tide over balance of payments difficulties. Second, inflation has effects on the desire for liquidity in speculative and precautionary motives. Weakening traditional modes of liquidity will encourage consumption and discourage saving and will exert influence on investment and reduce investable resources. As the normal sources of liquidity do not offer protection against the erosion of the value of money, investable resources will move into housing, gold, and other assets that seem to provide a hedge against inflation. Third, there will be an uneven impact on the distribution of incomes. As fixed-income groups struggle to catch up in their incomes, other factor incomes might increase disproportionately to their role, exerting greater stress and strain on the social cohesiveness of society. Fourth, without financial stability, progress in achieving other goals, such as growth, would be slower and would become increasingly difficult. More significantly, the erosion in the confidence of the community as a result of inflation will have a wider, unquantifiable, but enormous impact. Okun graphically described the
situation: "when the economy goes wrong, nothing goes right. Its malfunctioning robs us of our self-confidence. It creates distrust. People feel squeezed and cheated and hunt for the villains and oppressors. So when we most need productive partnerships to solve our problems, we are confronted with disunity."\(^1\)

These four effects illustrate the need for comprehensive action to restore stabilization and the community’s faith in the value of money. To achieve the goal is difficult and requires hard choices. Implementing the policies will involve painful adjustments and, presumably, loss of political support in the short run. If the goal is to receive political support, experience illustrates that inflation could be a potent weapon during the period for which the proverbial memory of the voter is short. If, however, the faith in a statesman is restored, with adequate public discussion and support, implementing these policies may become somewhat easier.\(^2\) Policies should not reflect frequent changes from an overriding commitment to reduce inflation to moderate deflation the moment signs of a recession appear. Anti-inflation policies take longer and need steady adherence to the ultimate goal.

**ROLE OF BUDGET**

The impact of the budget on the economy and its role in the management of the aggregate demand has been analyzed earlier. The issue, however, is whether the management of the demand has translated itself into a coherent policy for the control of inflation. If it is recognized that the current rate of inflation is not necessarily the result of government deficits, it would then be appropriate for anti-inflation policies to be oriented to other factors, particularly those that have added to costs. Viewed from this point, and based on the experience of both industrial and developing countries, four factors of budget activity merit recognition. First, on the tax side, increases in


\(^2\)Okun compares the acceptance of anti-inflation to an individual going on a diet “overeating is lots of fun and fundamentally enjoyable: Going on a diet is painful, and it brings few results in the short run. . . . And there is no clear-cut boundary line between normal weight and overweight.” However, as the risk becomes serious “we are tempted to go to the other extreme and adopt a starvation diet. The choices are never easy and they demand a great deal of maturity” (Arthur M. Okun, 1970, pp. 31–32).
indirect taxes have a tendency to contribute to higher costs and in due course to increased prices. Second, governments may often increase the money wages of their own employees and, through legislation applicable to the whole economy, the minimum wage. This in turn leads to increased production costs. Third, maintaining price supports for the farming community in industrial countries frequently leads to a cost-price spiral. In developing countries, the incidence of such farm support is uneven and is more prevalent in monoculture economies where marketing boards are required to provide remunerative prices. Fourth, expansion of social regulations, particularly automobile emission controls for ecological purposes, and related health standards frequently lead to increased costs. These aspects show how government budgetary activities could lead to higher costs and higher prices. They have not been given due recognition earlier, partly because of the preoccupation with financing the budget deficit and partly because some of these measures, particularly the impact of regulatory expenditures, general wage increases, and the impact of tax increases on the cost push, are not appropriately analyzed in the budgetary process.

The deficit of the government budget is another important factor that contributes to inflation. Conventionally measured deficits generally are those of central or federal governments and exclude, for lack of statistical data, the deficits of state and local bodies. While in some countries local governments are not permitted to raise loans in the market, in countries like India the deficits of state governments are financed to a major extent by credit from the central bank. The aggregate deficit of all governments may be financed differently in industrial and developing countries. In industrial countries it is financed by the sale of securities to the public and to the commercial banks, which prefer government bonds for reasons of high yield and less risk. In some countries, securities held by commercial banks are rediscounted, while in the Federal Republic of Germany the central bank provides no rediscounting on government bills. In developing countries, government securities are held mostly by the central bank and by other captive funds of government, such as provident and pension funds. Empirical investigations into the financing of debt in selected developing countries in Africa, Asia, the Caribbean, and Latin America for the decade 1967–76 show, for example, that in Botswana, Korea, Swaziland, Trinidad and Tobago, and Tunisia sizable portions...
of the deficit were financed by external borrowing. (This includes project borrowing from international financial institutions.) In other countries, particularly in Ethiopia, Guyana, Guatemala, Jamaica, Peru, Thailand, and Zaire, a major part of the budget deficits was financed by the banking system, in particular, by the central bank. While the relative roles of external borrowing and borrowing from the central bank and captive funds have changed over the period, reflecting the growth of other domestic financial institutions, the fact remains that growing deficits contributed to greater liquidity, money supply, and inflation.3

The budget deficit when initially formulated is based on a prognosis of the economy. The perception of the economy itself may contribute, and indeed has contributed, to further inflation. The experience of several industrial countries during the early 1970s suggests that the money illusion has been working heavily with fiscal planners, contributing to more liberal transfers and social security payments that very soon outstripped the available revenues and made resort to bank financing imperative. Further, the prognosis of the economy itself may be made more favorable than warranted. In turn, this has led to situations where expenditure could not be curtailed, resources could not be raised for fear of adverse effects, and greater budget deficits fueled further inflation. When developing countries prepare their budgets, inadequate attention was paid to inflation-induced declines in real revenues and the impact of inflation on expenditure. In practice this meant that the initial budget was formulated on what was considered a reasonable deficit and, as the year progressed, the widening of the deficit loomed large and greater resort was made to inflationary financing. Unwittingly, the budgets, in the course of their implementation, and in terms of their deviation from the original plans, became instruments of inflation.

**IMPACT OF INFLATION ON BUDGET**

The central element in the above behavior is not merely the budget impact on inflation, but the impact of inflation on the budget. The elements of this impact have been studied on an empirical basis and,

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notwithstanding the diversity of the approaches to these studies, certain broad features of the impact may be stated. For analytical convenience, these are provided in Table 13; these conclusions are not universal and are subject to serious limitations. The impact of inflation on revenues and expenditures is based on their respective elasticities and lags with which they react to changes in the economy. If budgeting were to be an automatic exercise, all that would be needed would be to ascertain the elasticities and lags and apply them to the annual forecasts of GNP. Realities are, however, more complex and much is dependent on the revenue system, the operational framework for the collection of taxes, the composition of expenditures, and much is dependent on the rate of inflation and the period for which it lasts. If the rate of inflation is high and if it is not chronic, the elasticity of some income taxes may even overwhelm the lags in collection in developing countries and will have a favorable impact on total revenues. If, however, inflation persists, that advantage would be lost, payment lags would be longer as they would favor the taxpayer, and there would be a decline in real revenue. The effect on nontax revenues is dependent on the rapidity with which interest rates are adjusted and tariffs for government services and products are changed to reflect the impact of inflation. The overall effect is likely to be neutral, however, as government also.

pays interest on its borrowing and to that extent is adversely affected. Revisions in tariff may permit the continuation of the previous fiscal balance, but this is unlikely to show any improvement. It is more likely, given the political difficulties and the reluctance to change prices frequently, that the overall impact on the budget will be negative. Thus, depending on the nature of the tax system and the rate and duration of inflation, there may be an increase in real revenue and the working of the fiscal drag may become more apparent, or the real value of revenue may remain unaffected or may even suffer a reduction.

The impact on expenditures is far more diverse and reflects the variety of expenditure. Expenditure on wages and salaries is likely to rise primarily because their revision is often linked to a price index. As the objective of public salaries is not merely to buy a service but to be competitive, to maintain parity, and to maintain a standard of living for its employees, it is possible that expenditures on wages and salaries will rise. More often, however, these adjustments are made after a gap and frequently the adjustment is for a past period rather than for current or prospective periods. Where salary levels are pegged to an index, total expenditure will increase with a constant lag but in line with inflation. Other transfer payments—pensions and subsidies—are likely to register sharp increases. Pensions are often related to an index and the volume of subsidies to government-owned enterprises and to other enterprises will rise, depending on the extent of price restraint sought by government in essential goods and the rate of inflation in other traditionally subsidized sectors. The major sector of government expenditures that is adversely affected is the general category of other goods and equipment. A major component of current expenditure is fuel consumption, the price of which tends to fluctuate with inflation. In capital expenditures, purchases of land and existing buildings (the prices of which increase both for speculative and inflation reasons) and

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5 The tendency for tax revenue to rise faster than GNP because of the effect of rising real incomes and inflation in a progressive tax system is called a "fiscal drag."

6 In measuring inflation-induced expenditures, it should be noted that measurement in terms of GDP will always show that the rate of spending on wages and salaries increases faster than general prices. This aspect, known as the relative price effect and discussed in Chapter 7, implies that government spending on personnel is invariant with regard to inflation, as it is assumed that there is no gain in the productivity of employees and that increases in the volume of service is achieved only through manpower increases.
### Table 13. Inflation Impact on the Budget

<table>
<thead>
<tr>
<th>Budget Categories</th>
<th>Likely Effects</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income, net wealth, and inheritance tax</td>
<td>Positive</td>
<td>Inflation is likely to gain more receipts. However, the gains are dependent on techniques of assessment and collection. Government will be adversely affected if inflation prevails over a long period and if the interval between accrual and liability and payment is long.</td>
</tr>
<tr>
<td>Indirect taxes: Customs: Taxes on goods and services</td>
<td>Positive/Negative</td>
<td>Impact is dependent on the specific or ad valorem nature of taxes and duties.</td>
</tr>
<tr>
<td><strong>Nontax Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest receipts</td>
<td>Positive/Negative</td>
<td>Governments are both creditors and debtors. Government’s revenue position will improve if interest rates are adjusted quickly. As an extension of this, its expenditures will also increase.</td>
</tr>
<tr>
<td>Fees: Transfers from public enterprises</td>
<td>Negative</td>
<td>Considerable lags in price adjustments, which generally occur, contribute to government losses.</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>Positive/Negative</td>
<td>Impact is dependent on the rate and timing of adjustment, made in public service salary structure. Automatic adjustments will lead to greater government outlays.</td>
</tr>
<tr>
<td><strong>Transfer Payments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest and debt retirement</td>
<td>Positive/Negative</td>
<td>Impact is dependent on size of debt, level of interest rates, and rate of inflation. If bonds and interest rates are indexed, government outlays will be higher. Delays in adjusting interest rates and absence of indexation contribute to government gains.</td>
</tr>
</tbody>
</table>
Table 13 (concluded). Inflation Impact on Budget

<table>
<thead>
<tr>
<th>Budget Categories</th>
<th>Likely Effects</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Transfer Payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pensions, etc</td>
<td>Negative</td>
<td>If indexation or other similar automatic arrangements exist, government expenditures will be higher. Magnitude is dependent on share of transfer payments in total expenditures</td>
</tr>
<tr>
<td>Subsidies</td>
<td>Negative</td>
<td>During periods of inflation, subsidies tend to become open ended owing to lags in price adjustments</td>
</tr>
<tr>
<td>Other Expenditure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel and energy expenditure</td>
<td>Negative</td>
<td>Extent of expenditure increases are dependent on amounts of energy consumption and pattern of subsidies</td>
</tr>
<tr>
<td>Purchases of equipment and machinery</td>
<td>Generally negative</td>
<td>Private sector price adjustments are quicker and contain margins for expected rate of inflation and delays in payment by government. In countries where the public sector’s imports are large, extent of government losses will be higher, depending on the rate of inflation in the exporting country and the type of equipment.</td>
</tr>
</tbody>
</table>

Equipment reveal that price adjustments are faster in the private sector and the overall impact on government expenditure is negative. In construction, there is usually a provision in the contract allowing the price to be adjusted by reference to wages and material costs paid by the contractor. Because of this escalation clause, government expenditures on construction tend to move contemporaneously with inflation. These factors would be evident from an analysis of expenditures in terms of functional classification. Agencies such as Defense, Public Works, Transport, and Communications register a higher rate of increase in expenditure because equipment and construction is the largest component. Agencies that employ more manpower, such as...
education, have lower increases in expenditures, as public service salaries lag behind the general rate of inflation.

A major finding of empirical investigation has been that expenditures in developing countries adjust faster than revenues to inflation.\(^7\) This conclusion is debatable for both assumptions made in investigations, as well as for more practical considerations. It was assumed in the formulation of the model that, in the short run, it would be difficult to reduce government commitments and expenditures and, therefore, these are automatically adjusted to keep pace with inflation. This implies a pure mechanistic approach by the policymaker and assumes that he has no discretion. Experience does not lend support to this argument. The use of data is also weakened by the fact that they do not distinguish between volume and price changes and do not account separately for increases in expenditures following a depreciation in the exchange rate. Also, the nature of results changes depending on the deflator used. In fact, as pointed out in Chapter 5, salaries in public services have often lagged behind and, as shown in the following chapter, the reaction to inflation has been to reduce the expenditures at any cost. What emerges from the experience is that the overall impact of inflation in the budget is indeterminate. In countries with highly elastic tax systems the impact in the short run may be beneficial. In countries that have less elastic tax systems, the impact on expenditure being greater, inflation contributes, for technical and administrative reasons, to increased deficits in the short run.

**Approaches to Budgeting**

The approaches to budgeting in an inflationary context reveal several weaknesses that affect the overall budgetary process. One common approach that had a good deal of acceptance at a practical level, and that is still to be found, is one of wishing the problem away. Support for this approach may be considered from several angles. For example, it is suggested that ignoring the problem could eliminate the tiresome business of deciding how much to put in the budget estimates to reflect growing costs. Similarly, it is felt that explicit provision of increased pay and expenditures in the budget estimates may attract the

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critical eye of the legislature and of the public as well. More important, inadequate estimates may intrinsically be a good thing, as they may provide a powerful incentive to restrain spending within the budget by seeking compensating reductions in some areas. Explicit provision for inflation is regarded as a self-fulfilling prophecy.

Operationally, the above approaches converted themselves into budgeting based on prices prevailing at the time of the preparation of the budget. This, however, had an inconsistent application in that the likely increases in prices were used for estimating revenues and not for expenditures, and budgetary deficits with a downward trend were achieved. To the extent that there was any increase in prices affecting expenditures, it was expected that such increases would be offset by increased productivity in government services. These approaches did not have any discernible consequences, as long as the rate of inflation was low and increases in expenditure were compensated for by increases in revenue, which, despite the recognition of the price impact, had an adequate margin. But with increases in the rate of inflation, it was recognized that these approaches had limitations. Productivity increases could not match up with the rate of inflation. The effort of using the prices prevailing at the time of the budget preparation proved a liability, for there was a considerable gap between the compilation of estimates by agencies and the implementation of the budget. This approach had a twofold effect. First, there was difficulty in interpreting expenditure proposals and assessing their financial implications and in evaluating the impact of budget on inflation. Second, the agencies went through a scissors effect of reduced allocations as a part of anti-inflation strategy and erosion in real terms in its expenditures. To a certain extent this may have been a balancing mechanism in the economy as a whole. Fellner argued, for example, in his treatise on wartime inflation, that a decision that seeks to allocate more than 100 percent of available resources to the various claimants cannot be executed, and that inflation functions as a mechanism for revising the supposed decision in order to make final shares within 100 percent. In normal administrative life, however, budget formulation and management became difficult. It became a series of crises and allocation of funds came to be made for meeting dramatic crises, such as a transport strike, a doctors' strike. As each case threatened public

convenience, funds had to be allocated to them, although this meant, in the process of decision making, a neglect, sometimes benign but more frequently deliberate, of other needs and claims. In countries that had medium-term plans, the budgets ceased to fulfill their annual role as the direction of the budget and the economy and their mutual interface became difficult to identify in the welter of ad hoc approaches.

POLICY OPTIONS

The experience clearly indicates that inflation cannot be ignored or compensated for by balancing mechanisms between revenues and expenditures or productivity gains, but must be explicitly recognized so that for coherent fiscal policy, budget estimates can be properly analyzed, reviewed, and improved. There are several ways in which this objective could be attained. Essentially, and on the basis of the experience of several countries, three different approaches may be considered.

The first is to anticipate the rate of inflation and provide for estimates that reflect increasing wages and prices. The rate of inflation itself is influenced by several exogenous factors, including the fiscal position of the public sector itself. The rate is then used for explicit provision in the detailed budget estimates. In the early 1970s, Australia, the United States, and some developing countries resorted to a "lump sum provision" for the purpose, which would then be allotted to different agencies. This lump sum was intended in the United States to cover the costs of procurement and other expenditures and, as the rate of inflation grew to double digits, it was considered more convenient to make detailed provisions. This approach implied that the effect of inflation would be fully taken into account and that expenditure programs would not be crippled. A variant of this is adopted in developing countries. Under this approach, no provision is made for inflation in the initial estimates and, as inflation is experienced, supplementary provisions are made. But this, however, is more of a crisis management approach.

A second approach, which is applicable mostly to the United Kingdom, is to evolve medium-term plans in real or constant terms and to make adjustments at the beginning of the fiscal year for the rate of inflation and to provide needed amounts. In both approaches, the
key element is the rate of inflation forecast for the next year; like all forecasts, there is a speculative element in the prediction of this rate. The rate has its own impact on other aspects, particularly wage bargaining, and on the behavior of the agencies. The problem is, however, that if the actual rate of inflation is higher or lower than the estimated rate, there would be expenditure excesses or, alternatively, shortfalls. Some elements of expenditure are particularly difficult to forecast and are dependent on a larger group of exogenous factors. For example, subsidies are demand related and difficulties are experienced in forecasting them. Much the same could be said about transfer payments, which may increase or decrease depending on the state of the economy. The methods by which these overruns (or unanticipated inflation) are accommodated lead to the consideration of other approaches to inflation budgeting.

The third approach, which was used in Canada during 1977–79, was to organize a "reserve against statutory overruns." The problem faced by Canada and a number of other countries was that expenditures under entitlement programs that specify conditions of payments to the beneficiaries in law tended to exceed estimates owing to unanticipated changes in the economy. These expenditures, which were called statutory in Canada, were to be contained within the limits of the reserve. The concern of the reserve was with expenditure overruns, while shortfalls were considered to be more manageable.

The need for containment of expenditures is seen in these approaches as a key element to restrain the budget deficit, otherwise the increase in the deficit would generate more inflation. In countries such as the United States and the United Kingdom, where the maintenance of estimated deficit level is an important policy element, an option is to maintain all expenditures other than the entitlement type and to

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9 For political acceptability and in the belief that it will have tighter financial control, many governments underestimate the rate of inflation. The experience of the United States and the United Kingdom suggests that when the actual rate of inflation is higher than forecast, it is seen by the public as lack of control and failure on the part of the government.

10 An analysis of expenditure overruns in the United Kingdom for 1977/78 and 1978/79 reveals that major shortfalls in estimated expenditures occur in subsidies to nationalized industries, capital expenditures, and in procurement of equipment for defense. Part of the problem is due to initial overestimation. An analysis of these aspects is found in Carolyn Jutsum and Graeme Walker (1979), and Valerie Imber (1980).
permit the movement of deficit within reasonable limits, provided that change is totally ascribable to entitlement payments. A variation of this approach is to accept the amount of deficit as given and to mobilize additional revenues for meeting the impact of unanticipated inflation. Yet another option is to maintain the deficit as planned and to undertake expenditure reductions or adopt a combination of expenditure reductions and increase in tax rates. These options illustrate the imperative need for estimating prices in an appropriate way.

**INFLATION BUDGETING**

In budgeting for inflation or, more appropriately, in providing for an explicit recognition, measurement, and linking of price inflation for both revenues and expenditures, distinction has to be made between medium-term planning purposes and short-term budgetary needs. The concern here is with shorter-term purposes of the preparation of the annual budget. In formulating a budget for meeting and reflecting on the inflationary content in the economy, it is assumed that the sources of inflation and its nature have been identified and that necessary policy options have been made. Within that policy framework, two approaches to budgeting may be distinguished—the economist’s and the budgeteer’s. These two functions do, in practice, overlap or may be combined in a single office in a government. Notwithstanding such a combination, there is a difference in the approaches. The concerns of the economist are with the aggregates and the balance in the division of resources between the public and private sectors and how this balance, particularly the opportunity cost of expenditure, will be affected by inflation. The tasks of the budgeteer, while working within that framework, is more at the disaggregated level as he ensures the proper basis for estimating revenues and allocating expenditures. The economist’s choice, reflecting his concerns, is to use national accounts, which provide, in constant prices, the patterns of public sector demands over time and on the acquisition of the real resources of the community. These aggregate accounts do not provide the same facility to the budgeteer, who has to consider the differences in the nature of the resource acquisition among agencies and to make appropriate procurement arrangements. While there is no easy compromise between these approaches, as each one of them has a vital purpose and
complement each other, it also appears that they have influenced the choice of instruments over the years, thus causing a degree of complexity. It is essential to recognize that these paths are not independent and do converge at various points in the budgetary process.

The preparation of revenue estimates in an inflationary context is less complex than the preparation of expenditures. For income and corporation taxes, the elasticity of the tax system, the lags in collection, and the accepted assumptions for price increases during the period provide a reliable guide for estimation. Such estimates should take into account the extent of fiscal drag and the adjustments that are considered necessary to reduce the drag. Taxes on domestic transactions and taxes on international trade, to the extent that they are specific, would be based on the projected levels of production or imports. As for fees and other rates charged by the government for its products and services, it has now become customary in government to revise them with a lag rather than in anticipation of the increased rate of inflation.

Government expenditures offer a wider range of issues reflecting the different tasks of each agency. Expenditures are incurred for personnel and also for the procurement of sophisticated technology to produce atomic energy. These two items illustrate the range of services available. What prices should be used by government to forecast expenditures in an inflationary environment? Economists tend to support the use of a single index for preparing forecasts, while the budgetary experience of industrial and developing countries shows that agencies prefer detailed prices reflecting the plant and machinery used by them. A traditional approach has been to use, at the aggregate level, the GDP deflator. The GDP deflators, it must be admitted, are difficult to forecast, and refer to a basket of commonly purchased items at some convenient point of time that do not always reflect the nuances of the variety of public expenditures. Furthermore, these deflators may be influenced by special factors such as commodity price increases overseas that may not altogether be relevant to public sector

11 In the GDP deflator, the average price of a bundle of goods and services representative of the total output of the economy in a base year is designated 100. The average price of a bundle representative of output in year 19− divided by the base year price is the GDP annual deflator for 19−. The same approach is used for extrapolating for a future year.
management. There is, however, a dilemma that confronts the policymakers in this respect; for measuring the balance in the economy a policymaker requires a general price index, while for budgeting more detailed indices are needed. If the former is used for budgeting, there is a possibility that it will understate the requirements of the public sector. But the use of more detailed indices within the government may require the use of similar price indices for the private sector, so that the demand for resources for both sectors may be denominated in a comparable fashion. The development of such indices would involve greater investment of resources, which, apart from being difficult, may not be attainable in the short run. Therefore, reliance has to be placed on expedient approaches; if detailed indices are to be used within the government they would have to be adjusted to be compared with the private sector. Such adjustments may involve arbitrary elements but these will be no more than are now in use in the compilation of national accounts. This approach has the advantage, in addition to being realistic, of minimizing the wider margins of error inherent in the use of a single index.

Specifically, the three main categories of expenditure that vary with inflation are expenditure on wages and salaries, transfer payments, and expenditures on capital formation. The use of GDP deflators on wages and salaries, as noted in Chapter 7, tend to overstate the share of public spending in GDP. Determination of annual manpower requirements of government is based, in any event, on the more practical measurement of increase in work load, additional tasks undertaken, and related factors. Therefore, a more appropriate base for predicting wage and salary expenditures by the government would be to formulate it with reference to the expected increase in the national average and the lag with which government salaries are revised, as is done in Japan and Sweden. In developing countries, some types of emoluments are

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12The Armstrong Committee in the United Kingdom has suggested the use of a general price index to measure the impact of expenditure plans in an inflationary environment. To this Committee, the question of which price index is to be used is unimportant, as long as consideration is given to the issue whether import prices are to be excluded by using the expenditure deflator rather than the GDP deflator and whether the index should exclude the output of public goods and services as this is not to be counted in the measure of opportunity lost, see Armstrong (1980), p. 22. It could be argued that inflation is measured in terms of the changes in general prices and to that extent a price index would be appropriate. When inflation is serious enough to be a big issue, the several general price indices might move together.
revised on the basis of the consumer price index and projections of that index would then form the basis for the government’s own expenditure. Similarly, transfer expenditures, particularly pensions based on price indices, are also adjusted. A thorny issue arises in regard to subsidies to specific industries and to government purchases of land, buildings, and capital machinery and equipment. In this respect, the use of sale prices of broad sectors of industry relevant to general and government purchases would be more appropriate.

The use of these indices does not and should not imply that government revenues and expenditures are automatically linked to selective indices and that allocations would be made to maintain the real levels. On the other hand, the use of these indices has two basic purposes—first, to ensure that there is a proper reckoning of prices and that assumptions regarding future price increases, nominal budget amounts, and the real levels of programs are all mutually consistent, and second, to ascertain the adjustments needed either by mobilizing additional resources or by reducing expenditures in real terms if the budget deficit is to be maintained at the amount forecast. The absence of these implies a money illusion and a budgetary policy that lacks purposiveness.

Inflation budgeting adds additional responsibilities to budgeting and planning agencies at the central level. It is appropriate that the central agencies, which have the responsibility for national economic management, also provide guidance on the price assumptions to be used by different agencies. Provision of such guidance implies a detailed framework of economic planning. In many developing countries, as noted earlier, planning continues to be largely an exercise in allocating resources for investment purposes and there has not been rapid progress in the anticipation and measurement of inflation. Relegating this responsibility to the agencies would lead to confusion, disparate assumptions, and lack of consistency in the policy framework. Central guidance would also be needed for the selection and utilization of sector-oriented indices. These additional responsibilities are necessary inconveniences in an inflationary era and the tasks of policy management would be considerably eased if adequate attention were paid to these aspects. Will these problems be less if there is selective indexation of revenues, expenditures, and debt? Is indexation a better alternative to discretionary action? What are the relative advantages and disadvantages?
ASPECTS OF INDEXATION

Reflecting the rapid increases in prices and the difficulties in adjusting categories of the budget to changing prices, selective indexation of revenues, expenditure, and debt has been undertaken by a number of industrial countries and, to a lesser extent, by developing countries. Although indexation as a phenomenon received wider attention during the early 1970s, the concept itself has a good deal of history. As early as 1887 Alfred Marshall observed in a memorandum to the Royal Commission on the Values of Gold and Silver "that Government should provide a tabular standard of value for optional use within the United Kingdom in all transactions which extend over a long period of time. . . . A theoretically perfect standard of purchasing power is unattainable. . . . But the index numbers with which we are already familiar would give ten times better standard of value for optional use within the country in long-standing contracts than even a true bimetallic currency." Since then, indexation of one type or another has been used in government transactions. The use of the term itself has, however, introduced an element of confusion into the discussion of the subject. It has come to be considered as being restricted to the adjustment of investments, savings, or bonds, generally by an index assumed to reflect the change in the general purchasing power of money. In practice, however, it is appropriate that usage of the term should include the changes in contractors' prices, as well as changes in a number of other areas. In this larger sense, some kind of indexation is observable, even if on a smaller scale, in government transactions.

Over the years the issue of indexation has generated a good deal of debate, and opinion is evenly divided between those who see it as an imperative need and others who view it as virtually giving up the fight against inflation. The need for indexation is argued for several reasons.

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13 In some countries indexation was used as a curb on the excessive enthusiasm of the legislative bodies in providing benefits to certain sections of the community. For example, in the United States social security benefits were indexed, as it was found that frequent revisions in benefits voted by Congress were entailing more expenditures. The benefits were, therefore, indexed. But with rapid increases in inflation rates after the mid-1970s, expenditures also rose.


15 See, for example, United Kingdom, Inflation Accounting (1975c), pp. 233–34.
First, when inflation persists at a high rate over a prolonged period, it becomes desirable to introduce indexation to preserve the basis of economic life and to mitigate the adverse influences of inflation on saving and investment. Second, the impact of inflation is uneven and unfair to those sections of the community where pay or receipts cannot be adjusted and, therefore, indexation is needed to insulate real incomes. Third, indexation of loans would protect the investor and promote greater mobilization of financial resources for the government. Fourth, that it will not have the lags and other drawbacks that are inherent in any system in which corrective action is sought through discretionary action. Those who are disinclined to indexation refute these arguments.\textsuperscript{16} The applicability of these arguments differs, since wage settlements, as distinct from other settlements, evoke different responses. The relevance of these purposes and arguments is to be seen more in terms of specific budget categories.

Indexation has been applied for income taxes in a number of countries of the Organization for Economic Cooperation and Development (OECD). This was done primarily to mitigate the inequitable impact of a progressive tax system with high elasticity, which, through the working of fiscal drag, obtains more revenues for government. While normally an increase in tax rates during periods of inflation would win approval as a policy choice, it is the inequitable and arbitrary nature of the revenue increases that is questioned. Furthermore, the full operation of fiscal drag could in due course, prove to be deflationary. Indexation, on the other hand, will maintain the tax equity and will help stabilize real output by sustaining real disposable income in the context of rapid price increases. In practice, however, indexation is not applied in its entirety to the tax system—the most notable exceptions being excise duties and other taxes on sales and related transactions—and, when applied, is done retroactively through administrative action. Several countries have a system of bracket indexation, while a few others seek to minimize the impact of inflation on company taxation by frequent but ad hoc reliefs. Governments have been, by and large, reluctant to index systems lest the buoyant revenues that enabled them to hold down deficits would

\textsuperscript{16}This opinion was in evidence in the later periods of the nineteenth century. See Finch (1956), pp. 2–3.
be lost and they would be plunged into greater deficit, with attendant adverse impacts on the economy.

The indexation of expenditures is relatively more widespread, although there are noticeable differences between industrial and developing countries; in both, indexation of wages is widely prevalent. In most countries, wages are linked to a cost of living index. In Brazil and Israel, wages move along with changes in the index, while in several other developing countries they are adjusted after a lag through deliberate government action. Social security payments, particularly unemployment benefits and pensions, are generally indexed in OECD countries and in a number of Latin American countries. Certain types of income maintenance programs, for example, food stamps, and nutrition programs are similarly linked to a price index. An additional feature of benefit indexation is that the adjustment is generally automatic and contemporaneous rather than lagged. Capital expenditures, except for specific contracts, are not pegged to any index per se, although escalation in costs is recognized and compensated for.

The relevance of indexation for debt has received additional stimulus since the mid-1950s, in both industrial and developing countries. If the concern in industrial countries is to recoup the original purchasing power of government bonds, the additional feature in developing countries is the need to promote small savings by the public and to channel them into government finances. Unless appropriate protection is offered against erosion by inflation, it is felt that the public will not be interested in buying government bonds. Those who favor indexation argue that it is the moral duty of the state to refrain from

17 The Brazilian experience indicates that during the mid-1960s wage revision was based on real wages during the previous 24 months and by additional amounts equal to one half of projected inflation. However, as the projection was always on a conservative basis, real wages declined. To avoid this, another formula was devised in 1968 under which the excesses of actual inflation over the projected inflation period, during the previous contract period, were compensated for. A temporary decline in real wages was still possible as wage contracts were usually signed for a year. See Jack D. Guenther (1975), pp. 24–29.

18 In the early 1950s, numerous government organizations, particularly public utilities, issued bonds that were pegged to their specific products or services, for example, price of a kilowatt hour, railway tickets for travel. In Israel bonds were repayable, up to the mid-1960s, in U.S. dollars. With successive devaluations in currency, this procedure was abandoned and are now linked to the consumer price index.
"defrauding" bondholders via inflation, that indexation will actually prove to be helpful in promoting saving, and that, on the whole, it will bring in the needed resources to the government. These considerations can be and have been subjected to a variety of considerations, including the fact that the issue of a guaranteed purchasing power bond would encourage inflation by removing a fixed-sum asset holding group from among the ranks of anti-inflationary pressure groups that influence government policy. It is also suggested, and evidence supports it, that the increase in savings need not necessarily contribute to reducing inflation, as many offsetting increases in expenditure will neutralize that. Also, to the extent that the bond issue is supported by the central bank, it will contribute to greater liquidity. Furthermore, when debts are repaid, there will be increased outlays that may aggravate inflationary pressures. Much is also dependent on the actual use of resources raised through bonds, which, when utilized for purposes other than the expansion of real capital, can be saddled with a debt burden that cannot adequately be serviced by the growth in real output. An argument implicit in the indexation approach is that the real interest rate under inflation should be the same as the rate under conditions of monetary stability. This may not in fact be so, as the interest rate that a borrower would be willing to pay depends on the type of inflation. The inherent rates tend to have a premium during periods of inflation which should be adequate for attracting bond purchasers. Specifically in regard to developing countries, it is agreed in a context where a major part of the debt is held by foreigners, who may insist on exchange rate guarantees, governments may not be enthusiastic about this. Also, once there is indexation with reference to a price index that includes indirect taxes, governments may not be willing to raise revenues by revisions in the rates of indirect taxes, for each such revision would also imply higher debt service charges. Experience shows that indexation in industrial countries is primarily on long-term loans to protect the small saver. In developing countries, excluding Brazil, greater reliance is placed on the utilization of captive funds (provident funds, trust funds) for raising debt capital. There has been,
however, a growing consensus for a selective and flexible indexation approach within the overall policy framework.

**ISSUES IN INDEXATION**

The approach of indexation is considered an implicit defeatist attitude toward the problem of inflation, that it is a shelter from the effects of taxation, and that once initiated it will prevent consideration of other alternatives and will in due course generate pressures for the extension of the system to all financial transactions.\(^ {22} \) Indexation of wages implies an automatic movement that may not involve negotiated settlements. Those who support indexation argue that lagged adjustments to prices lead to welfare losses and that it is naive to suggest that negotiated wage settlements would be any less than automatic ones. The whole issue is dependent on the impact of indexation on the stabilization of real output in the context of changes in demand and ability to control inflation. On both these counts, the debate is inconclusive. It is also clear that indexation does not offer a cure to the hydra-headed nature of inflation faced during recent years. At a practical and operational level also, indexation raises a number of issues. First, timing is of crucial importance. Efforts at maintaining the levels of taxation and expenditures as of a particular date imply a judgment that the level is appropriate for the economy. There is a probability, however, that indexation might take place at a wrong point in the business cycle. Second, there is the question of the appropriate index to be adopted for the purpose.\(^ {23} \) In some countries, indexation was introduced with reference to the consumer price index, while in some OECD member countries, it had reference to wages. The consumer price index may, however, have an upward trend even when the prices of manufactured goods are stable, and at times the increases in the price index may be so large that for economic reasons there is no need for offsetting adjustments. If indirect taxes and

\(^ {22} \) For a consideration of the issue in the United States in the early 1950s, see United States, *Monetary Policy and the Management of Public Debt: Their Role in Achieving Price Stability and High-Level Employment* (1952), pp. 888–89.

\(^ {23} \) Finch (1956) suggested that in view of the lack of a reliable price index in some countries, it might prove helpful for an international body to advise on the construction of a suitable index (p. 16). Since then there has been considerable progress in the development of data.
increased oil prices are included in the index (as they are), it implies that by indexation, increases in excises and sales taxes and oil prices will automatically lead to indirect reimbursement by the government. In some cases, the index could be distorted by administered prices and subsidies. The issue also arises whether certain sections of society should be given preferential treatment. Beneficiaries of social security systems fare better than average wage earners in some countries, as their benefits are based on a price index.\footnote{In Israel pension payments were indexed not to the cost of living index but to the prevailing nominal basic salary of the rank in the civil service held by the pensioner.} Other issues of major importance include the frequency of adjustment (once or twice during a year) and whether the benefits should be adjusted to past or prospective rates of inflation. In the process, the computation of the index itself has become a major contending issue—should it be an all-embracing single index or a series of selective indices?\footnote{The construction of the index itself may be a subject of fraud. See Cohen (1966), p. 452; also Finch (1956), p. 20, on the selection of the index.} Prevailing practices reveal, for obvious reasons, preference for several indices.

In the final analysis, the choice of indexation is dependent on the old debate about discretionary action versus indexation, and about medium-term planning, which has built-in factors for annual adjustments for changes in the rate of inflation. The experience of indexation, despite extensive debate, has been rather limited. Even in countries like Brazil and Israel with experience of indexation, it is limited to wages, pensions, and government long-term debt instruments. To that extent there has been greater preference for discretionary action. While such action has the potential for some lags, it also enables government to formulate policies for changing situations, rather than leaving them to automatic adjustments. Medium-term planning of the rolling expenditure forecasting type has also been helpful in anticipating problems and has had as many facilities as indexation. The crucial problem area has been one of forecasting the rate of inflation. If annual correctives are made in medium-term expenditure plans, the role of indexation becomes academic.

\section*{Inflation and Program Management}

The impact of inflation on program management may be analyzed in terms of the effects on central agencies and on spending departments.
The central agencies, which have the responsibility for managing the budget, are confronted with difficult tasks, particularly when a major part of expenditures is for transfers to other levels of government, subsidies to productive sectors, and transfers to households. As noted above, a feature of the industrial countries is the extensive prevalence of social security systems under which benefits are indexed. In a context of high rates of inflation these expenditures, as noted in Chapter 1, grow along with the cycle rather than being countercyclical. As a consequence, the central policymakers have lost a good deal of control and are hemmed in on all sides by commitments that have already been made and over which they have no discretion.

At a program level, inflation imposes greater burdens on managers. Such burdens accentuate when programs have to be implemented within specified resource ceilings. Inflation demands that the program manager be aware of the differential impact of price changes on his program content, that he is able to forecast the rate of inflation, and can contain the outlays when the actual rate of inflation is different from the estimated rate. This requires, in turn, a cost awareness, an information system that provides data on the progress of the programs, as well as changes in the prices of goods and services used by them, and a decision-making framework for making adjustments. Experience of both industrial and developing countries suggests that these are areas where more progress is needed. Specifically, there is a need for a mechanism that would "cap" the outlays when the actual rate of inflation is higher than the estimated one. The United Kingdom has introduced a system of cash limits to meet this problem.

**Cash Limits in United Kingdom**

The system of cash limits, which was selectively introduced in the United Kingdom in 1974/75, was extended to a major part of the Government in 1976/77. The limits were essentially indications to the spending departments of the amounts that would be available to them. The limits incorporated prespecified allowance for inflation and were intended to convey a financial discipline by making clear the amount of money that the Government was prepared to pay in the year ahead and some purchases were to be cur to the limits if prices were too
In its operational form, the system indicated the maximum amounts to be spent on blocks of services. Initially, the coverage of cash limits was limited but was extended later to cover central government transfers to local governments and nationalized industries for capital expenditure. As a part of the system, an elaborate reporting framework was also introduced to facilitate the introduction of corrective action.

The cash limits system is not without its shortcomings. One major limitation is that it does not cover the entitlement outlays, which continue to grow with the rate of inflation. Its success is dependent on the precision with which the actual rate of inflation is forecast and is likely to be fulfilled when the margin of error is minimal. If the actual rate of inflation is substantially higher (as it can be as governments tend to underestimate the initial rate of inflation), then the gap can be so wide that the implementation of cash limits would be rendered doubtful. The experience of the United Kingdom suggests that when the rates of inflation are forecast well, additional expenditures would be needed during periods of recession (1980/81) to alleviate the financial stress on nationalized industries. Apart from undermining the confidence of the system, frequent revision of cash limits to meet exigencies could trigger uncertainty in the spending departments.

While these problems persist, it seems appropriate that cash limits be viewed as a framework in which benchmarks are set to provide guidance. Such guidance, while obviously useful, also has limitations, and should not be viewed as a complete solution to problems of inflation but rather should be considered as a technique to be used judiciously in conjunction with other techniques.

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27 The Armstrong Committee considered cash limits as a crude device for controlling public spending and felt that it was not a durable system in situations of wider gaps between estimated and actual rates of inflation (see Armstrong, 1980). Another limitation of the cash limits system is its one-sided stress on budget expenditures.
Traditionally, the role of government expenditures was examined in terms of their contribution in fighting recession through stepped-up outlays on public works. With the persistence of high rates of inflation and recognition that public expenditures have, in part, contributed to the continuing crises, on the one hand, and compulsions of growth and antirecessionary policies, on the other, more importance has been attached to the upward and downward movements of expenditures over the short and medium terms. To be sure, changes are taking place all the time in government expenditures, but the specific issues relate to the role of expenditures in demand management and the extent of the stimulus to be provided or the restraint to be exercised. What tasks are inherent in this exercise? How do expenditures affect the economy and the living standards? Although changes in expenditures influence vital aspects of the community, the literature has been quite meager on these subjects. Studies in economics have mostly considered compensatory policies and the efficacy of public works programs. Public administration approaches, as revealed in occasional government reports, have been more concerned with the need for stability in expenditure and consideration of the delicate relations between the central and spending agencies in making expenditure adjustments. The lack of literature, which in the event is inversely related to the importance and impact of government expenditures on the community's welfare, may have, in part, been due to the feeling that the subject is a part of the arcana of government functioning. This chapter...
considers theoretical and other pragmatic approaches to the role of expenditures, to the problems of adjustment of expenditures, to the specific issues faced in making adjustments, and to a discussion of the issues in increasing and reducing expenditures in the short and medium terms. The chapter is primarily concerned with the financial aspects. While the political aspects are important, it is assumed that some broad choices have already been made on the character of adjustments.

**ROLE OF EXPENDITURES**

Public expenditures were for a long time considered as potentially powerful elements in managing total demand in the economy. But their use was resisted until the late 1960s, in view of some theoretical and practical considerations. Important among these considerations are the theories offered by Musgrave in the late 1950s, and the practical, public-policy-oriented recommendations of the U.K. Plowden Report Committee in the early 1960s. As both views had influenced public policies, it is appropriate that they are considered in detail. Musgrave's conceptual framework consisted of the allocation, stabilization, and distribution branches. The allocation branch is a balanced one and changes only with shifts in the preferences between government and private goods. The stabilization branch is not in balance and may have deficits or surpluses in accordance with the state of the economy. The distribution branch is balanced by taxes and transfers. Within this framework, Musgrave believes that changes in the amount of public expenditures should not be used to stabilize aggregate demand. This view is in conformity with his general framework in which the amount of public services is determined by the willingness to pay and where the community's preference is revealed through the voting mechanism. A logical extension of this approach is that, if the community does not want a service, the option is to change the government. Insistence on this framework would, however, mean that expenditures cannot also be used to stimulate demand during the

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1 In the early 1930s European countries made extensive use of public expenditures in balancing budgets. For an interesting account of these experiences, see Hugh Dalton (1933), pp. 437–56.

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low phase of the cycle. Musgrave believes that public works expenditures have no place among efficient services but are to be preferred to a "do nothing" policy. Conversely, it is also wasteful to cut expenditures because of inflation. The principal concern of Musgrave is to maintain the proper amount of public services, which in his framework is there to begin with through the voter's preference. He, therefore, argues that expenditure changes are not required unless it can be shown that consumer demand for social needs varies over the period of the trade cycle. Both these contentions are debatable. If the criteria for changing public expenditures is only through the community's demand for social services, it would be possible to use government expenditures as countercyclical instruments only when the requirements of stabilization policies are internalized and revealed through the voter's preference. However, given the market imperfections and gaps in information, the voter's preference cannot be expected to fully reflect the complex requirements of stabilization policy nor, in a practical world, would it be possible for the government to wait for the preferences to be revealed. Stabilization is a governmental role, and it cannot be fulfilled in the mechanistic style that the Musgravian framework implies. Moreover, Musgrave specifies a proper level of public services. In reality, the level is not immutable but has been changing over the years, reflecting the undercurrents of social philosophy and the voter's preference. The important considerations in public services are how much and when. Both these issues remain unanswered in Musgrave's framework. However, it should be recognized that the relatively recent phenomenon of persistent high rates of inflation and the government's own possible contribution to that were not evident in the late 1950s when Musgrave formulated his analytical framework.

If Musgrave's framework implies unchanged, perennially stable public expenditures, Plowden's demand for stability in expenditure was proposed in an environment in which there was too frequent "chopping and changing," in which policy directions were blowing "hot and cold," and in which the remedy was "worse than the disease." The Plowden Committee felt that these changes in the level of expenditures impaired cost consciousness and financial discipline in government, that they frustrated efficiency and economy in public services, and that on the whole short-term economies in public expenditures were rarely successful and sometimes damaging and it
was best they be avoided.\footnote{Similar views were expressed in 1974. The Expenditure Committee of the House of Commons noted “changes in the level of public expenditure should be used only as a tool of last resort. . . . it should be regarded as a confession of failure when changes in the level of public expenditure . . . are made and then reversed on a countercyclical basis” (United Kingdom, Public Expenditure, Inflation, and the Balance of Payments, 1974, para. 19).} To remedy the situation, the Committee suggested that stability of expenditure policy formulated in terms of maintenance of aggregate public expenditure aligned with prospective resources would have beneficial effects on the working of the spending departments by encouraging a “firmness of judgment and lucidity of criteria and priorities.” The Committee, despite its decisive thrust for a stable expenditure policy, recognized that some changes in government expenditure were inevitable but hoped they would be small but significant and timely. Subsequent experience, however, indicates that while the implementation of the Plowden Report established a medium-term planning pattern, stability in expenditure could not be attained partly for lack of political support and partly because of changing economic climate.\footnote{See Peter Vinter (1978), pp. 18–31.}

Changes in economic events brought about changes in government approaches to public expenditure, as the traditional reservation of using public expenditure policies to help manage overall demand had yielded in the short run to more flexible approaches. Two factors contributed to this change in the perception of the role of public expenditure. The primary one was that the significant growth in public expenditure and the persistence of inflation had contributed to the view that if inflation were to be reduced, a beginning had to be made by reducing government expenditures. Second, it was recognized that the public sector could no longer be insulated against the burden of adjusting its own operations, leaving the onus of adjustment entirely to the private sector. These changing views led to the search for new control mechanisms and to variations in public expenditures as instruments in both phases of the trade cycle—to add stimulus to demand and to restrain demand through increases and reductions in public expenditures. The “inviolable” character of public expenditures fell a victim to the economic developments in the 1970s. These changes, in turn, generated new issues for budgeting and expenditure controls.
DILEMMAS OF ADJUSTMENT

The events in the 1970s reaffirmed the important role of fiscal policy as a major instrument of contracyclical policy packages. The choice, however, is whether short-term changes in policy are to be achieved through changes in tax rates or through changes in expenditures. The debate has, over the years, acquired active proponents who support primary or exclusive reliance on tax rates both by virtue of their technical superiority and also because of what are perceived as difficulties in expenditures. While difficulties—apparent or real—in reducing expenditure are considered below, it must be recognized that reliance on taxation implies a shift in the burden of adjustment to the taxpayer, whereas reliance on expenditure adjustment causes the burden to be shared by the government and the private sector. Those who question the inconvenience of cutting back government expenditures do not seem to be particularly sensitive to the burden of reducing private expenditure.

Supporters of tax change argue that tax increases or surcharges lead to reductions in demand throughout the economy without creating distortions in specific programs that expenditure cuts might imply, that tax cuts might be more appropriate for stimulating the economy, and that, in any event, taxes offer ample steering room in the budget to meet short-term policy goals. The effectiveness of the tax system is, however, dependent on the features of the system, the element of progressivity, the coverage and basis of taxes, and the efficiency of the tax collection machinery. Developing countries with a tax ratio of less than 20 percent of GNP that rely extensively on indirect taxation, or that exempt major sectors of the economy such as agriculture from taxation, would have only limited facility in the use of taxation. In countries where budget revenues are primarily dependent on a single mineral source, the flexibility is negligible and, in any event, private sector incomes are mainly dependent to a major degree on government expenditures. Thus, pragmatic considerations indicate that the pack-

5Adherents of monetarist and rational expectations theories generally assert that variations in either government expenditures or taxation are ineffective for stabilization purposes.

6Sir Douglas Wass (1978) noted “if the brunt of short-term fiscal policy changes falls on the tax side, the burden of adjustment falls mainly on the private sector. The consequent costs of disruption in the private sector may as well be as great as the costs of disruption in the public sector” (p. 100).
age of fiscal measures, which are largely derived from the basic features of taxation and expenditure, should not be exclusively reliant on a single source but should require an appropriate combination of both revenues and expenditures.

The dilemma of the exact choice and the combination of the relative roles of taxation and expenditures is also based on the role assigned to the private sector. Regrettably, however, the impact of government operations, particularly expenditures, on the private sector and the relationship between government and private sector in the provision of social services have not been examined in any detail in the literature. Discussion has tended to be full of assertions that reveal some asymmetry in reasoning. The role of public expenditures in stimulating economic recovery is generally accepted on the premise that, even if development by private enterprise is preferable, there is no reason to believe that it would perform the tasks associated with economic recovery. Indeed, if it had been so capable, it would have prevented a recession. On the other hand, when the general phenomenon is inflation, it is suggested that government should cut back and that private enterprise should be allowed a greater role in the provision of goods and in satisfying social needs. While reductions in government expenditure are justified insofar as they are contributory factors to the cycle, it is not so certain that they can be used for assigning a greater role for the private sector. Such an enhanced role may, however, be justified in terms of the political philosophy, and in a particular phase of the cycle. Yet another factor that merits recognition is the type of complementarity that exists between the government and private sectors in the social services sector. Specifically, in regard to medical services, health, and education, both government and private sectors provide services to the public. In some cases, both make concessions for lower-income groups, although it is generally believed that it is only the government that offers such facilities. In principle, for certain sections of the community, private care and support may often be alternatives to public care and support and different social services may be substituted. The impact of reductions in government expenditures on sustaining social services is very complex and little is known about it.7 Reductions in public housing may be compensated for by

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7 See Rudolf Klein (1978) for a discussion of these aspects with reference to the United Kingdom.
increasing private amenities and similar substitutions could take place in other sectors. Thus, in aggregate, reductions in government expenditures may not necessarily imply drastic consequences for the level of services. But the differential impact of government and private programs would be different for various income groups. It could also be argued, although without an adequate empirical basis, that private services may be relatively cheap, as public services tend to become more expensive during an inflationary phase, while in the private sector, with greater attention on costs and emphasis on acquiring shares of the market, they could be less expensive. Such logic would be considered specious, particularly when the implication is that the private sector would miss an opportunity to increase its profits. Regardless of the private sector’s behavior, the issue is its role both in terms of sharing the cost of adjustment (increased taxes) and in greater provision of services in some sectors (greater investment). This dilemma cannot be satisfactorily resolved as a technical fiscal matter alone and is to be seen within the wider context of the prevalent political philosophy. The choice of the instruments—taxes or expenditures—depends on the much larger choice of the role of the state.

PUBLIC EXPENDITURE ADJUSTMENTS

The role of fiscal policy as a countercyclical strategy involves both upward and downward movements in public expenditures. In regard to the increase in expenditures to stimulate demand, there is a fundamental difference in the technical approaches of developing countries and industrial countries. In the former, it is viewed as a structural problem and development plans are evolved to create the appropriate growth opportunities. In industrial countries, the aggregate demand is maintained through automatic stabilizers and through public works programs to compensate for the decline in the private

8The Second Five Year Plan (1966) of the Government of India noted “in a developing economy the basic trend of governmental operations in the fiscal and monetary field is inevitably expansionist. Expenditures could be stepped up and credit made available in ampler measure should recessionary trends unexpectedly appear. However, the problem in the main is likely to be one of regulating inflationary pressures. Creation of new demands somewhat ahead of supplies is part of the strategy of development. It follows that a curtailment of public expenditure and other curbing devices can and ought to be used only in the last resort” (India, Second Five Year Plan, 1956, p. 38).
sector's activity. The built-in stabilizers comprise unemployment doles, transfer payments intended to alleviate the burden on certain classes of people, and social security payments. These mechanisms are automatic and workers become eligible for payments from government soon after they become redundant in industries. If the period of the cycle can be forecast with reasonable accuracy, then governments can initiate action through budgets to minimize the cyclical impact.

Depending on the likely duration of the trade cycle in industrial countries and the different phases of growth in developing countries, plans and budgets are formulated for the medium term for increases in expenditures. These operations become more complex when they have to be carried out within shorter periods. Changes in the economic climate that, in turn, require proper responses from the budget are basically of two types. First, changes in the economy are recognized in advance and appropriate policy revisions are made in the budget. Second, changes take place in the economy after the budget is presented, thus negating the premises on which the budget has been formulated. To meet the new situation, a minibudget or a series of measures would be needed to correct the course. The first type presents few problems for budgeting as the issue is recognized and the budget content changed. The second type poses intractable problems and could involve reversals in policy directions. Some revisions may be carried out within the existing budget framework, while others would need changes in the economic basis and the relevant budgetary law. The burdens of adjustment differ depending on whether the proposed action is for increases or reductions in expenditures. While increases in expenditures do have implications for mobilizing additional resources, there is a widely shared belief that it is a feasible course of action. Reductions in expenditure, however, were often considered not only unwise but infeasible. From a budgetary point of view the problem has been considered with an attitude that borders on being defeatist. These considerations range from philosophical to institutional and operational, all of which factors merit consideration.

The philosophical considerations emphasize the community's own anticipations about continued services and the political acceptability of the sacrifices involved in reduced expenditures. Dahl and Lindholm point out that government expenditures mean that "services are performed, values are realized, administrative organizations developed, expectations expanded, clienteles formed, interest groups
created, pressures mobilized, and once these are set in motion, they cannot easily be contracted.” These arguments were advanced at a stage when the imperatives of a welfare state were to further expand its services. In contrast, the growing tax burden, as well as what is perceived to be the inefficiency of government, has brought another view of the role of government. It is undoubtedly true, however, that in the traditional world the community’s expectations have been considered linear. Views may vary if there is an option between greater burdens or greater benefits, which illustrates the basic fact that there are no immutable laws that govern expenditure increases and reductions and that the considerations are more pragmatic and dependent on the state of the economy and the level and components of public expenditure.

The institutional hurdles to reductions in expenditures are associated with the features of the budgetary system. First, a major problem in Latin American countries and similar areas is that a substantial portion of the budget is earmarked. Although the incidence of such earmarking is far from uniform, there are other similar arrangements that reduce the effectiveness of the annual budget. In addition, most budgets have sections of expenditures that are not subject to annual appropriations and are therefore beyond the budget review. Second, anticipation of changes in the economy would require a reasonable system of forecasting. As noted in Chapters 7 and 8, facilities in this regard are still at a nascent stage in developing countries. The facility in forecasting has a direct impact on the use of the budget as an instrument of countercyclical policy and to the extent that likely events are not anticipated and corrective action initiated, the problems of adjustment of expenditure tend to be compounded. Conversely, the existence of a forecasting system would, in due course, provide the authorities with flexibility to vary the parameters of fiscal policy. Third, governments may not often be endowed with freedom to move

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9 R. A. Dahl and C. E. Lindholm (1956), p. 362. It should be noted that government expenditures have not always grown and there were periods when they were reduced. Many colonies had experienced slashed budgets depending on the exigencies on the home front. For a detailed account of Indian expenditures prior to independence and the pressures to reduce expenditures, see A. Premchand (1966b), Chapter VIII; and Dalron (1933) provides an account of the international experience in reducing expenditures in the late 1920s and early 1930s. For a review of the recent Australian experience, see R. B. Scottton (1978).
budget outlays and receipts in either direction, except with the approval of the legislature. Several contingent powers have, however, been given in recent years to governments to vary indirect taxes within limits. Expenditures reveal more varied experience. As noted previously, budget estimates as approved by the legislature imply a negative commitment in that no sums above the authorized amounts would be spent by the government. There is no positive commitment for it to spend the amounts. Technically, therefore, governments have powers in certain situations to restrict spending. But in countries such as the United States, where annual appropriations imply a greater commitment to spend, the presidential authority to impound spending is somewhat restricted.\textsuperscript{10} In some countries, unspent amounts constitute reserve amounts and the spending departments have a claim on them. Even where governments are endowed with appropriate authority, reductions in expenditures would not presumably be attempted for fear of public reaction. Such views are, admittedly, reflections on the use of power rather than on institutional rigidity, which itself varies depending on the legislative system. Fourth, a major institutional bottleneck is that the responsibility for fiscal policy is often with the central government, but the latter's ability to achieve any success is dependent on the spending patterns of its agencies, particularly public enterprises, and other branches of state and local governments. Often, however, other levels of government may show a fiscal perversity and spend more when restraint is needed or less when stimulus is indicated. Although coordination devices between branches of government are evolved to meet a broad range of functions, lack of explicit coordination for fulfilling fiscal policy aims may thwart the achievement of reductions in expenditures. (To some extent, this applies to increases in expenditures too, but, in general, increases have met with greater compliance than reductions.)

The operational factors reveal yet another problem area. Budgets in some countries are adopted by the legislatures with reference to the new contractual commitments that government departments can make. These contracts have long lead times and reversals are difficult.

\textsuperscript{10}During 1971–73, some impoundments were made by the President which were construed by the legislature as executive incursions into the legislative domain. Eventually, this contributed to the introduction of new budgetary procedures in the Congress in 1974.
Budget outlays represent heavy commitments already made and cutting back these outlays, apart from being operationally difficult, is considered to be economically inefficient and costly. The implementation of projects, in order to be efficient, may require assurances of continuity in budgetary allocations. Also, the planning of reductions and their implementation takes almost a year and it is felt that either the phase of the cycle would change within that period or the required measures may be taken in the next budget.

Combinations of the above factors have gathered additional strengths during recent years. As a result, expenditures have tended to be classified into natural and artificial,\textsuperscript{11} controllable and uncontrollable,\textsuperscript{12} and expenditures that can be changed by administrative process and those that involve changes in law.\textsuperscript{13} Implicit in these classifications is the assumption that government expenditures are rigid and cannot be reduced in the short run. In support of this general approach, more arguments are advanced by governments. It is suggested that each time additional expenditure is undertaken to combat recession, the probability is that outlays will be ratcheted upward, as such increases prove rewarding to groups of individuals or sectors participating in the process. Most outlays, particularly outlays for maintenance, which tend to move upward with additional capital outlays, would be difficult to reduce as a majority of them have little to do with the cyclical state of the economy. In addition, transfer and entitlement payments tend to increase with inflation and their automaticity cannot be eliminated. Viewed from this angle, it is suggested that the annual element of flexibility in the budget is about 3 percent of the total, which may not be significant if countercyclical

\textsuperscript{11}See, for example, Murray L. Weidenbaum (1969), Vol. 1, pp. 357–68.
\textsuperscript{12}This distinction is used in the United States. Empirical surveys conducted on the approaches of budgeteers indicate that they would be reluctant to approach the uncontrollable outlays mainly for the reason that there is not much to be gained in reviewing them. Many agencies in the United States felt that zero-base budgeting (1976 onward) was not suited to uncontrollable programs. The surveys illustrate two points. First, the solutions to uncontrollable outlays lie in appropriate policy changes rather than in techniques of control. Second, the broad acceptance of some outlays as uncontrollable contributes to an atmosphere of accepting their inevitability. The gradual growth of this feeling tends to permeate the governmental process and, in the medium term, its impact could be more devastating than the influence of any vested interest.
\textsuperscript{13}The practice in Denmark and the Federal Republic of Germany.
strategy is to be successful. Even if expenditures are reduced, it could prove to be a measure of false economy in the short run, for in the long run expenditures on maintenance and personnel emoluments will catch up and will lead to more significant increases.

These views, which in a way have formed into a lobby, imply that once expenditures are incurred, that fact alone is adequate to allow their perpetuation. A closer examination of the issues suggests that "uncontrollability" has been used as a convenient alibi for inaction. The classification itself is arbitrary and, as an accounting distinction, it is not too clear whether its contribution has been anything more than a disservice. Clearly, extraordinary changes in the economy would require other than ordinary measures. Technically the law can take away, in whole or in part, what it has given. Therefore, the key issue is in terms of contribution and the role of expenditures in countercyclical policy. Denial of the role would provide a built-in growth in expenditure and would work as a destabilizing force whose impact cannot be neutralized even with a potent tax system. When the government budget is the primary contributor to destabilization, there is little reason to expect that it can be corrected by the tax system alone.

**FORMULA FLEXIBILITY**

Fiscal policy formulation in general and specifically in relation to stabilization has been frequently characterized by three lags. First, there is a recognition or identification lag, which refers to the quality of economic intelligence and reporting available to the decision maker, time taken in collecting additional material needed by him, and the quality of forecasting. Second, there is the administrative lag in that considerable time is taken to formulate policy responses. The administrative lag also includes the time taken to implement the formulated policy measures. Third, there is the legislative lag in that the legislature may take more time either because of the deliberation

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14The period prior to the onset of the depression witnessed some heavy reductions in expenditures to balance budgets. Strong measures were taken by Australia and New Zealand, among others, to reduce expenditures. See Dalton (1933), p. 450. Similar experiences are to be found elsewhere in less turbulent times.

process or reluctance to make changes and approve the policy packages of government. Although this lag may not show the legislatures as they wish to be seen, it appears true that delays occur and that these could hamper the advantages to be gained in the proper timing of expenditure adjustments. As these lags make the budgetary process less effective, it was suggested that an arrangement whereby changes in taxes and expenditures to meet specific types of developments in the economy be legislated in advance, offering in effect a viable program that could be launched without loss of time. This formula flexibility is an automatic pilot that is tailored to structural relationships of the economy and its dynamics. Its main advantage is that it reduces the time lapse between recognition and administrative lags and would reduce the discretionary action to narrower limits. While, in theory, this approach has considerable appeal, its transition to the real world is more problematic. In the first place, evolving a formula that will initiate appropriate action is difficult. It requires clearly defined choices and objectives, sophisticated modeling, and a comprehensive grasp of all possible configurations of the economic future. The approach also assumes that stabilizing action can always be prescribed in advance, although in reality what matters is the degree of adjustment. If formula flexibility is available in full measure and if the formulas are perfect, they would absolve the policymaker from any discretionary action. In practice, however, there is a role for the policymaker as he has to distinguish between legitimate and false signals and the trade-off among options (e.g., unemployment versus inflation) and make necessary changes in policy. Although there are difficulties in achieving formula flexibility, the very search for a formula also suggests that consideration be given to an ideal framework in which government budgetary policies could be formulated. In considering the features of such a system, it should be noted that the search for a formula has in some measure contributed to the introduction of automatic stabilizers during periods of recession and to the provision of contingent powers to governments for taking action pending legislative approval.

The ideal system can be said to have four features, some of which characterize the budgetary process itself. First, the economic and social objectives and the priorities of government should be clearly stated. Both original budgets and changes have to be evolved within this framework. Second, the budgetary approaches should be specific not
merely at the macrolevel but also at the microlevel. Third, adjustment in expenditures presupposes the existence and easy availability of detailed information on projects and programs, their legislative and funding status, their present stage in financial and physical terms, the time lags between construction and the beginning of the flow of benefits, and the impact of outlays on demand. These data enable the formulation of policies fully recognizing the impact and effectiveness of the different categories of expenditures. Fourth, flexibility in the traditional system has been limited to stabilizers during recession. Some payments are linked to the price indices that automatically trigger additional government spending. As a reverse of this proposition, it could be envisaged that these payments should have trigger clauses requiring fresh consideration after expenditures reach specified limits. This ideal system is certainly not in position in governments. Indeed if it were available, expenditure adjustments would be undertaken in a routine way and formulation of countercyclical fiscal policy would not be an issue. However, as the actual systems vary from the ideal, as is to be expected, suitable bridging measures in the form of planning the adjustments are needed.

**PLANNING EXPENDITURE ADJUSTMENTS**

Planning public expenditure adjustments is technically seen as a process for determining the increases and reductions in government expenditures in the short term to reflect sudden changes in economic conditions. Short-term adjustments should not imply a sacrifice of the future for the present and need to be planned to avoid such events. Although in the abstraction of economic models annual growth of government expenditure is largely considered to be discretionary, the policymaker will find that in the real world it is a vastly exaggerated notion. His flexibility or lack of it should not be seen as matters that are to be taken on faith or trust but are to be ascertained through an actual survey of the changes in conditions and the consequent changes in the budget. Adjustment of expenditure implies that a reallocation of resources in a form different from the pattern in the budget is needed. It also implies that reallocation requires to be taken as seriously as the first exercise. There cannot be one set of rules for allocation and another for reallocation or that the latter should become an innocent rite but that it should stand the test of scrutiny as the first exercise.
The changes in the budget may be needed prior to its submission to the legislature but after the formulation has been completed, or any time during the period of the validity of the budget. In planning the adjustments, there are considerations of a broader, as well as of a specific, type. Included in the broader framework are the constraints that are to be recognized formally and explicitly. For example, it is necessary to recognize at a policy level that the alternative to expenditure adjustment is not a deficit financed by money creation. Also to be recognized are the lags between the introduction of corrective action and the emergence of their effects, so that the precise period of the timing of the impact can be pinpointed. Measures may have to be taken over a period and efforts have to be made to ensure that measures calculated to balance one budget do not lead to the unbalancing of the next. It is necessary to ensure that there is close coordination and consultation between central agencies and spending departments, for without these the latter may be tempted to resort to escape mechanisms. These mechanisms need to be anticipated and regulatory and control mechanisms strengthened to avoid their occurrence. Further, short-term changes should conform with the long-term objectives and should, in any event, be an aberration with minimum hindrance. Without such conformity, changes in expenditures will be indiscriminate and will distort the process of growth. At the same time, closely coordinated functioning between plan and fiscal action should not mean that long- or medium-term plans should be rigid. The magnitude of adjustment is also important. If the order of variation of expenditure is low, it is unlikely to have any impact on the economy and the whole effort has the potential of becoming one of misdirected energy. The considerations involved can be presented in the form of a planning matrix showing lateral as well as vertical considerations of expenditure adjustments (Table 14).

The aim of expenditure adjustment is to exercise deliberate influence on the final aggregate demand in the economy through subtle or significant variations in expenditure. In choosing between various courses of action, the differential multiplier or withdrawal effects of public expenditures need to be carefully reviewed. For this purpose, expenditures are reclassified (Table 15) in terms of their content and influence. If expenditures are merely increased in transfer payments, little will be accomplished if the real need is to increase investment outlays. Planning expenditure adjustments cause the
### Table 14. Planning Expenditure Adjustments: A Framework

<table>
<thead>
<tr>
<th>Expenditure Blocks</th>
<th>Functions and programs (e.g., agriculture)</th>
<th>Nature of adjustment</th>
<th>Duration of adjustment</th>
<th>Relevant total expenditure, including earmarked and other funds</th>
<th>Magnitude of variation</th>
<th>Adjustment's impact on the Plan</th>
<th>Adjustment and change in quality of service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumption</td>
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<tr>
<td>Expenditure</td>
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<tr>
<td>Wages and salaries</td>
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<tr>
<td>Other expenditure</td>
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<tr>
<td>Capital</td>
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<tr>
<td>Formation</td>
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<tr>
<td>Land</td>
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<tr>
<td>Buildings</td>
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<tr>
<td>Transfers</td>
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<tr>
<td>Transfers to other levels of government</td>
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<tr>
<td>Transfers to households</td>
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</tbody>
</table>
### Table 15. Planning of Expenditure Adjustments: Classification of Expenditures

<table>
<thead>
<tr>
<th>Expenditure Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Predetermined expenditures</td>
<td>Comprise interest, debt repayment, subscriptions, etc., and do not lend themselves to increases or reductions</td>
</tr>
<tr>
<td>2. Regular expenditure</td>
<td>Reflects outlays including some transfer payments incurred on current or ongoing policies. Reductions are possible through policy adjustments. In planning increases, new programs often present problems in projecting the rate of spending.</td>
</tr>
<tr>
<td>3. Expenditures that could be modified in the light of desired government influence</td>
<td>Reflect outlays of an investment or development character, including public works that could be adjusted in either direction</td>
</tr>
<tr>
<td>4. Expenditures dependent on economic climate</td>
<td>Outlays on subsidies, price supports, etc., which may be based on specified economic indicators. Outlays could ideally have trigger clauses so that consideration is given to policy options after a critical stage is reached</td>
</tr>
<tr>
<td>5. Demand-dominated expenditures</td>
<td>Lending and related operations by government are included in this group. The importance of this group depends on the magnitude and purpose of lending.</td>
</tr>
<tr>
<td>6. Contingent expenditures</td>
<td>Cover contingent liabilities incurred through government guarantees. Such outlays are relatively rare and unpredictable</td>
</tr>
</tbody>
</table>

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The composition of expenditure can change. It is particularly necessary to take into account the paradoxical effect of some types of expenditures. A notable effect is that, as a result of austerity measures in the budget, more people become unemployed and then they become entitled to unemployment benefits provided as part of the social security system. As the number of unemployed grows, transfer payments increase and, eventually, overall expenditures may be higher than anticipated and will also claim a higher share of GDP in a stagnant economy. To that extent, government deficits tend to be higher and continue to fuel...
inflationary pressures. Yet another effect is that cuts in capital expenditure adversely affect growth, in turn contributing to reduced revenues and larger deficits. Also, higher unemployment means reduced revenues. These aspects incidentally illustrate the complexity of expenditure planning and the futility of any search for formula flexibility.

Planning for increases in expenditure has had a long history since the Depression. Various budgetary techniques were used during, and have been used since, the Depression to formulate a contingent "shelf" of projects that could be initiated with little lag. Medium-term planning implies a capital expenditure program intended to stimulate aggregate demand. As noted earlier, the information demands of such programs are quite high and involve not "boiling pot" arrangements of an ad hoc nature but a more formal approach toward contingent planning. The important point to be noted is that, while a "path" is charted in a development plan or a medium-term forecast, planning for short-term adjustments involves projects that could be introduced and terminated with greater ease. The emphasis is on the nature of the projects and on their facility for quick implementation. Options between projects, transfer payments, and tax cuts, and their relative efficacy, will have to be evaluated as a part of this planning exercise.

Reductions in expenditures involve the basic questions whether they are envisaged for existing outlays or for a reduced rate of growth of future expenditures. The former involves more drastic and quicker measures, while the latter is less painful. Reduction in existing outlays involves forgoing existing comforts and experiencing reduced public services, while a reduced rate of growth affects only expectations. In both cases, expenditure reduction is only one instrument of the package and its linkage with others has to be consistent. Adoption of supply economics approaches implies that more attention should be paid to the impact of expenditure reductions on the quality of

16Dalton (1933) recognized this problem 50 years ago. He wrote "the cost on public funds of maintaining unemployed workers, however low the level of maintenance, rises as their number increases" (p. 11). This phenomenon occurred in the United Kingdom during 1980/81 and expenditures were higher than forecast because of higher payments for redundancy (United Kingdom, Economic Progress Report, 1981).

17The purposes of expenditure cuts may be negated by an easier monetary policy. The approaches have to be congruent for expenditures and monetary policy.
economic life in general and on industrial and labor productivity through reduced subsidies and income transfers. A thorough program analysis would be required to test the efficacy of ongoing programs. Does the program achieve the goals laid down in the original legislation or in similar specifications? Are the original goals of the program still appropriate and, if not, could they be terminated without unduly disrupting the industry or groups affected by them? Is the total cost of the program commensurate with the benefits achieved? If there had been an increase in the costs, is it due to physical or price factors? What measures can be taken to check their growth? Do some of the more important aspects need to be faced frontally? Greater surveillance is involved of the ways in which expenditure controls are operated, the points at which control is exercised, and the agencies and officials entrusted with the responsibility for exercising them.

Planning reductions in expenditure implies a heavy leaning against the wind. Spending agencies, clientele groups, and others tend to think that their favorite program should be exempt from reduction. In pursuance of their objective, political pressures are applied and campaigns organized. In the process, some programs become "more equal" than others. While in the final analysis political views prevail, at a technical level it is more appropriate that objective criteria be applied. Otherwise, planning expenditure adjustments will degenerate into an ad hoc exercise of controlling what can be controlled and cutting what can be cut rather than what should be cut, and thus will be self-defeating. More important, this exercise adds to public skepticism about the government's seriousness in policymaking.

**Expenditure Increases**

Although the issue during recent years has not been to increase expenditures, it is instructive to consider the experiences of industrial and developing countries in developing budgetary techniques in this respect. A broad range of techniques and programs used in this regard are shown in Table 16. The principal budgetary innovation made

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18 Writing about the Indian Government's efforts toward economy in expenditure, Sir Richard Temple observed "some who preach economy as a rule seem to think that a favorite project is to be the exception; the sense of its particular merits causes the general maxims to be forgotten" (India in 1882 (London: Macmillan), p. 449).
Table 16. Increases in Expenditures: Techniques and Measures

<table>
<thead>
<tr>
<th>Nature of Budgetary Technique</th>
<th>Measures Covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplementary budgets and contingency budgets</td>
<td>Emergency public works, large investment projects, increases in investment by public utilities, crash programs for employment of educated youth</td>
</tr>
<tr>
<td>Extended grants</td>
<td>Flexibility to spend beyond the fiscal year without further legislative approval</td>
</tr>
<tr>
<td>Cyclical equalization</td>
<td>Release of funds to specified projects/programs from funds accumulated during periods of expansion</td>
</tr>
</tbody>
</table>

during the depression years and followed since then relates to the introduction of general emergency budgets and extended grants in Nordic countries. Although there are variations on the themes among these countries, the purpose of the mechanism is to vote amounts and keep them for use without reference to the legislature. In Sweden, for example, the budgetary system has three instruments—General Emergency Budget, Relief Works Program in the Ordinary Budget, and a Contingency Reserve for Housing. All these are to be utilized for increasing expenditures to keep aggregate employment as high as possible during the cycle and to limit imbalances among regions and industries. The General Emergency Budget, with outlays voted each year equivalent to approximately 1 percent of GDP, represents an accumulation of a shelf of projects that could be launched immediately. To be eligible for inclusion, projects need to be in an advanced stage of planning, so that work could begin at four months' notice. The provision for a relief works program is made in the ordinary budget, or through supplementary budgets that are presented at least three times a year, and certain authorizations for relief work in road transportation and on similar projects are included in the emergency budget. In regard to housing, the approved programs include a contingency reserve that might be used, if warranted, by overall economic conditions and the status of labor in the construction industry. In addition to these, extended grants provide additional flexibility. The experience of Sweden during the early 1970s shows
that the General Emergency Budget was not used and that there was demand management mostly through relief works, housing programs, and increased investment by public utilities.

Conjunctural action funds or cyclical equalization reserves are used extensively in the Federal Republic of Germany. These funds are held at the Bundesbank and represent "excess" revenue (revenue that is in excess of the forecast because of higher prices and increased activity) transferred to a fund that is then used to finance expenditure during a downturn without having to resort to additional borrowing. (Part of these funds could also be refunded to the taxpayer.) Similar arrangements are found in other European countries.

The issues in increasing expenditures relate to the efficiency with which budgetary techniques are deployed and the effectiveness of the programs chosen for the purpose. It is not realistic to expect these programs to work with push-button efficiency; in fact, they need careful advance planning. The experiences of some industrial countries indicate, for example, that there is no easily accessible shelf of projects. Either because of this, or because of other factors, emphasis has shifted to programs whose main purpose is to distribute cash through training programs ostensibly designed to provide technical skills. The experience of oil exporting countries in the period after 1973 suggests that utilization of increased revenues took place primarily through stepped-up emoluments and other transfer expenditures. But such increases may bring more problems instead of stabilizing or managing aggregate demand. It is evident that undertaking judicious increases in expenditure is not as simple as it is often believed to be. The large shortfalls in such planned expenditures highlight the difficulties and stress the need for proper contingency planning.

**Public Works**

The majority of projects and programs introduced for increasing expenditures comprise what have come to be known as public works. The concept underlying public works is not new and, in retrospect,

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19. J. M. Clark (1935) pointed out that if programs and projects are planned in advance they cannot be put into operation at a moment's notice. It is not unrealistic to assert, however, that considerable progress has been made in this area since the 1930s.

20. T. S. Eliot wrote "A commission is appointed for Public Works, chiefly the question of rebuilding the fortifications," *Difficulties of a Statesman*. 

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may be ascribed to the extensive construction of forts and tombs by the Moghul rulers of India and of the churches built by Christian kings elsewhere. Public works have a variety of purposes and are used as a means of national development, as a stimulus to employment, and as a means of mitigating the crises. Both industrial and developing countries have made, and are making, extensive use of this policy package. The advantages of public works are that they can be designed to pay attention to low-income groups, are highly divisible, lend themselves to easy phasing and quick implementation, and, more significantly, their impact is visible. This is not, however, to suggest that all is well on the public works front. The experience of industrial and developing countries shows that the objectives of programs are rarely matched by end results. A major part of expenditure may be for payments to contractors rather than for labor. The impact of public works is obviously dependent on the magnitude of allocations and the financial priority assigned to them in the policy package. Often, however, pork barrel considerations appear to have a decisive influence on the location of public works and, because of lack of advance planning, amounts end up being spent on unproductive projects. With a more careful choice of projects, technology, and implementation agencies, it appears that more durable results could have been achieved. Especially in developing countries public works have tended to be concentrated on minor irrigation repairs that are ephemeral in nature and are lost with the onset of the monsoon. It is frequently suggested that there is not much perseverance in the public works efforts, and that more lasting benefits could be obtained through comprehensive operational planning.

**Reduction in Expenditures**

The techniques used for reducing expenditures and the measures typically covered by these techniques are shown in Table 17. The approaches to reduction in expenditures may be analyzed in terms of the techniques adopted, functional categories of expenditure affected, the economic categories of expenditure involved, spending agencies

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21 John Woodward Thomas (1974) points out that at least 15–18 developing nations, during the last two decades, have established special public works programs with employment as a primary objective (pp. 297–311).

Table 17. Reduction in Expenditure: Techniques and Measures

<table>
<thead>
<tr>
<th>Nature of Technique</th>
<th>Measures Covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Across-the-board cuts in expenditures: rescissions¹</td>
<td>General percentage cuts in all activities of government</td>
</tr>
<tr>
<td>Specific sector cuts: impoundment of funds²</td>
<td>Reduction in expenditure of specific sectors</td>
</tr>
<tr>
<td>Selection of quick-yielding projects</td>
<td>In the context of a resource squeeze and related imperatives for reduced expenditures. Reliance is placed on projects that have low gestation periods and quick revenue feedback, in preference to those with longer gestation periods and delayed revenue yield.</td>
</tr>
<tr>
<td>Reduction in expenditure on personnel</td>
<td>Reduction in administrative posts and not filling existing posts</td>
</tr>
<tr>
<td>Quarterly cash management budgets: cash limits and other adjustment mechanisms</td>
<td>Release of quarterly apportionments to spending agencies so that they are within limits of specified resources. Adjustment within those ceilings is a matter for the spending agencies to decide.</td>
</tr>
</tbody>
</table>

¹Rescissions as a technique is found in the United States and refers to proposals by the President for repeal of the previously enacted provisions.
²Impoundments—again to be found in the United States—refer to executive impoundment of funds authorized by the legislature.

that have a prominent role, and the impact of reduced expenditure on the distributional goals of government.

It is a common experience that most governments are endowed with powers to reduce expenditures, although such powers are somewhat more straitjacketed where legislative involvement in the budgetmaking is greater. In a British commonwealth country, reductions in expenditure can be undertaken by the executive. In the U.S. type system, the President did have the power to impound outlays approved by the legislature, if so desired, for purposes of achieving fiscal balance in the economy. This was, however, altered after the introduction of the Congressional Budget procedures in 1974. In other countries, notably in the Federal Republic of Germany and France, where powers were lacking, appropriate delegated authority was given during recent years. For example, under the Economic Growth and Stability Act 1967, the German Finance Minister was empowered to freeze the use
of certain funds, the commencement of construction work, and commitments for expenditures for subsequent financial years. He can also place limits on borrowing by Länder (state) governments. Certain other types of expenditure could be incurred only with the prior approval of the Finance Minister. In France, another technique (which is a reversion of the cyclical equalization reserves in Germany noted earlier) was experimented with in the late 1960s and was abandoned after a few years of experience. Under this procedure, the Government froze part of the investment authorizations and set them aside in funds for action (fonds d'action conjuncturelle). The funds, so separated, could be activated when there was a need to stimulate demand. In developing countries, finance ministries generally have powers to issue directives, abandon programs, or reduce outlays.

A common technique (variously known as an emergency brake or meat axe budgeting) used by governments is across-the-board cuts; this technique implies that all expenditures are treated equally.\textsuperscript{23} Over the years the use of the approach of across-the-board cuts has gained adherents and those who are strongly critical of the method. Among those who support it the technique is considered to be a fairly simple operation, it implies a fair share of adjustment to all, and it will bring a new level of equilibrium from which expenditures may grow. Implicit in this approach is the belief that there is a degree of slack in the existing level of operations, which, if removed, would not in any way reduce the efficiency of expenditures. Also implicit is a faith that somehow, once the shock is administered, things will work out largely through the working of the invisible hand. To the critics the technique is a negation of all budgeting and the manifestation of a refusal to admit realities. The simplicity of administration of the technique is deceptive and works adversely against spending agencies that have been provided with reduced allocations to begin with. The fair share thesis is also considered to be inappropriate. As the Plowden Committee reported “if any increase or decrease is required in the total

\textsuperscript{23} Across-the-board cuts could be used at various stages of the budget formulation. For example, this approach could be specified in the budget ceilings indicated to spending agencies for formulating their initial estimates. It could also be used after the review and approval of budget estimates but prior to the submission of the budget to the legislature, if such changes are mandated in terms of reduced resource availability; these cuts could also be imposed after the budget has been approved. The reference here is to the cuts made after approval of the budget by the legislature.
Government expenditure, therefore, the only sensible course is to decide to treat the Departments unequally.\textsuperscript{24} Also, to the extent there is a slack, it is most likely that its incidence will be more differential than uniform. Given that the impact of inflation on the finances of departments is not uniform, it is difficult to perceive that equal reductions in expenditure would be a solution. The more significant impact of across-the-board cuts implies, at least in the perception of the public, that quick cuts can be made, although in reality nothing is being reduced but only partly postponed. Moreover, in the practical world, use of across-the-board cuts may degenerate into centralized financial controls that tend to work in arbitrary, uncertain, ad hoc, and personal ways.\textsuperscript{25} The alternative to this is specific sector cuts, which imply the selection of programs that can be and need to be cut.

Yet another technique, much emphasized but actually less used than its full potential indicates, is the selection of quick-yielding projects and programs. Implicit in this approach is the belief that if projects with shorter gestation periods are chosen, they would make a quicker contribution to government revenues and that the pressures on government finances would be reduced. The use of this technique would ideally be reflected in the development strategy and annual budgets. By its very nature, this technique has greater relevance to developing countries. Experience indicates, however, that the policy emphasis on quick-yielding projects is not always accompanied by the introduction of budgetary techniques for identifying such projects, either in the financial planning stage or during the formal budgetary process. Even where relevant techniques have been used, their impact was not discernible because of the relatively negligible revenue yield, on the one hand, and the general increases in expenditure stemming from policy factors, on the other.

Other techniques used offer a variation on the theme of adjustment within given ceilings. Quarterly cash budgets under which apportion-

\textsuperscript{24} United Kingdom, Control of Public Expenditure (1961), p. 31.

\textsuperscript{25} The zeal and pleasures of "cutting" must be restrained. Otherwise indiscriminate cutting could prove a costly affair. The history of the late 1920s would repeat itself. In Australia, for example, all expenditures, including interest on internal debt, were reduced, foreclosures stopped, and hire-purchase agreements reopened. This, however, adversely affected the borrowing operations of the Government. For an interesting account of this experience, see Dalton (1933), p. 441.
ments are conveyed to departments, the system of cash limits (in the United Kingdom), and the envelope system (Canada) belong to this category. More recent variations of this approach are the "scrap and burn" technique in Japan and "tit for tat" in New Zealand, both of which imply that departments cannot seek expenditure increases and that if any increases are to be made they should be within the specified ceiling and taken up only in lieu of existing programs. The implementation of these approaches reveal a twofold difficulty: (a) in some cases, because of the exclusion of some functions from the budget and consequent limited coverage, the effectiveness of the system was reduced, and (b) spending agencies had to adjust their priorities within the allotted amounts, which was found to be difficult in the absence of a detailed framework of governmentwide priorities. These drawbacks should be seen more as areas that need further refinement. Yet another approach is to place increased emphasis on reviewing the existing programs to secure efficiency. The British practice of "scrutinies," initiated by Sir Derek Rayner in 1981, seeks to question the need for a program and the way it is carried on. Similar practices were adopted in Sweden as well. Essentially, however, this reflects an extended use of evaluation techniques that gain greater acceptance during tight economic situations.

Functionally, the experience of industrial and developing countries shows that the axe can fall on social and economic services, while outlays on security and related general administrative services are maintained. The axe on social services reflects a belief (a) that it contains many free services and (b) that reductions in government services may partly be compensated for by increases in the private sector's provision of services. Social services represent a politically sensitive area, and the areas chosen for the purpose are often directly dependent on the proportion of their fiscal influence. In a large number of developing countries, economies in expenditure are routinely sought through across-the-board cuts in nondevelopment expenditure in the hope that the savings so available could be used for development purposes. In reality, however, such savings prove to be illusory and, in the event, reductions may finally be made in development outlays. Reductions in capital and development outlays

26India had to drastically reduce its envisaged outlays for the fourth plan period owing to the failure of its general economy measures. See A. Premchand (1966a).
affect growth prospects and, as noted earlier, reduce the growth of revenues as well. Confronted with political difficulties for reducing existing expenditures, and also in view of the attributed rigidity of expenditure, governments have found it expedient to reduce scheduled outlays for capital purposes. The choice between development and nondevelopment expenditures is not a hard one from an economic point of view. When for political purposes the future is sacrificed for the present, it will be found out, before too long, that expedients demand a high price.

In terms of the spending authority, experience reveals that some agencies are selectively exempted from the operation of expenditure adjustments. Among those exempted are defense and development departments (for example, agriculture) in developing countries. This selective exemption implies a degree of “unequal” treatment, which is desirable.

From the viewpoint of the economic category, however, the two categories that are chosen for severe treatment are investment and personnel outlays. Investment outlays have been considered earlier. From the early 1920s onward, cuts in the pay of government employees and in personnel strength have been repeated and severe. The attention to personnel is only natural, for the lion’s share of outlays is on personnel payments. But this is also an area that is more difficult than others in view of the security of employment and the frequent use of escape mechanisms by spending departments to circumvent the policies.

Expenditure reductions also lead to changes in the distribution patterns. A change in the functional and economic categories of expenditures imply changes in their relative shares and in their distributional impact. Such impact is to be seen among different income groups, between rural-urban parities, and among regions and industries. Although detailed studies are not available on the incidence of expenditure benefits on distribution, it is tautological that the first-round effects of expenditure cuts would be a reduction in employment, unless compensatory developments take place in the private sector.28

27 One of the areas subjected to economy in the 1920s was war pensions and allowances. There was considerable resistance for such cuts but eventually they were made (Dalton, 1933, p. 439).

28 For a brief and impressionistic study of three countries, see Omotunde Johnson and Joanne Salop (1980), pp. 1–23.
Much would depend on the sector in which cuts are made and the purposes of related programs. Reduction in medicaid, food stamps, food subsidies, cuts in services to remote areas all affect the poor or the specific areas for which the services were intended in the first place. Whether these effects in the distribution pattern are in conformity with the policies of government or whether they have been unintended effects of indiscriminate application of budgetary cuts is, however, a separate matter.

The implementation of the above approaches has been associated with problems. There is little need to reiterate that expenditure reductions will lead to increased inefficiency and reduced quality of services unless such expenditure controls are carefully planned and targeted to specific programs. Moreover, it is suggested by those who have been engaged in the formulation and implementation of austerity programs that easier options for reducing expenditure have been exhausted, that such reductions may be obtained only when first applied, that deferral of maintenance expenditures cannot be sustained indefinitely, that catch-up on restrained programs would lead to more expenditures in due course, and that new programs of expenditures are becoming evident. The agencies in government tend to think that their initiatives and enthusiasms have been unduly dampened. The central agencies caught up in the cross fire between spending agencies and the quest for immediate results in the context of financial stability are not often sure in which direction they are moving. The public, for its part, wonders about the significance and direction of expenditure cuts when they find hospitals with declining services and libraries with no new additions.

These puzzles are symptomatic of the difficult financial times and suggest the need for greater, rather than less effort, for strengthening expenditure planning and control systems. The whole process of control is a delicate one in which a balance must be sought between the need for financial stability and expenditure cuts, between excessive action that might affect the achievement of the overall objectives and the limited actions that might defeat short-term objectives, and between easier methods of affecting reductions and the more difficult

choice of making planned cuts in areas that need to be cut. The situation demands an appropriate contribution on both policy and technical fronts and improvements in the processes. Expenditure planning would have to envisage the contingency of reductions and reversals of policies. A contingent plan of reverse priorities of programs and projects that could be withdrawn at short notice should necessarily form part of the strategy of the central agencies. These are to be planned in close consultation with the spending agencies to ensure compliance.

Budgetary systems in selected countries have already been reorganized for the purpose. In the United Kingdom, the Public Expenditure Survey System annually asks the spending agencies to indicate the programs that they can do without or reduce spending on; in Canada the "X" budget procedure routinely gathers data on programs that agencies would be willing to forgo in the event of reduced resource allocations. In the United States, the Zero-Base Budgering System collects information from spending agencies on programs for which reduced allocations will be accepted. In some developing countries, notably Bangladesh and Tanzania, "core investment programs" with priority were identified for funding in case of resource shortfalls. Despite these built-in features, however, available evidence does not indicate that these have been fully utilized. A future need is to make these features of budgetary systems fully operational.

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Part Two

STRUCTURES, SYSTEMS, AND FINANCIAL MANAGEMENT
Budgets: Structural Aspects

BUDGET CLASSIFICATIONS

There are several ways in which budget transactions can be classified. Some of these have been illustrated in the preceding chapters. Early in the development of budgeting and reflecting the concerns of the newly acquired legislative control, the primary consideration of budget classification was to provide a better understanding of the intentions and purposes of government for which funds were sought. As further progress was made and as legislative supervision was established in a clearer form, what influenced the budget structure was the manner in which accountability could be ensured. The objective was not only to provide information on what the government proposed to do but also to reflect an understanding between government and the legislature of the specific purposes of expenditure. The achievement of this accountability implied that there were enough safeguards within governments to accomplish the tasks inherent in the understanding. To this end, the budget structure was so devised as to indicate the full responsibility of the spending agency. The budget heads—or the nomenclature of the budget—were therefore devised to be related to each spending department. The budget structure provided accountability and a series of vantage points within government to control its own operations. Later, when for reasons of management and efficiency it became necessary to measure costs, budget structures had to be altered to take care of this additional task. Since the depression years and, more specifically, with the start of economic planning, other changes were needed in the budget structure. Major changes in the budget structure were first made for economic reasons during the
1930s, when the dual budget system was introduced in Nordic countries and later was emulated by other countries. After the introduction of economic planning, however, dual budgets acquired a new dimension and capital budgets became vehicles of development and growth. With the spread of national accounting, with the dominance of allocative efficiency concerns, and with the application of quantitative techniques of analysis, the need for redesigning budget structures for the new tasks became even more urgent. Priority planning, identification of objectives and their relationship to a function, and appraisal of the cost benefits and associated aspects exerted greater influence on evolving budget structures. To a lesser extent, requirements of international comparability also had some influence in designing the budget structures.

In this evolutionary process, due regard had to be paid to the classic principles of budget classification. The classification was to be pertinent, and was to serve not merely the legislative requirements but the changing requirements of the decision maker. It was to be consistent and uniform, for in the absence of these features, data on government operations would not be at all useful. The structure had to be practical and all objectives needed to be outlined in such a way that the many branches of bureaucracy could perform the tasks with the same degree of understanding. As governments grew and their transactions multiplied, the need for practicality became even more important. The structure had to be manageable and appropriate, but not excessively detailed or too broad in its characterization. To a great extent, these objectives were kept in mind when formulating budget structures. Given the diversity of purposes, however, no single system could have served all the objectives with equal success. Some would have been better served and some less. Where one or two objectives were dominant in shaping the budget structure, other objectives were served by supplementary or other auxiliary systems. The existence of these auxiliary systems should not detract from the merits of the overall structure but should more appropriately be viewed as a way of meeting diverse and occasionally conflicting requirements.

The budget reforms during the last three decades are in fact a history of the efforts to improve budget structures. The importance of the budget structure is more than the sum total of the above-mentioned parts. It stems from the fact that the budget structures, which aim at adapting information for the decision maker, have generated a system...
of values and an approach to decision making. The decisions reflected the concerns of the budget structure and many of the attributes of centralized financial control are to be found in the way in which the budget is structured. Although budget structures were originally conceived as a means, they acquired a unique status, which in due course dominated the attitudes on what is considered important and the general approaches on all matters concerning government finances. This set of attitudes became a discipline and was viewed as the single most important factor contributing to distortions in decision making. It was to remove some of these anomalies that budgetary reforms were initiated. However, technical details received less attention despite their importance. It was a matter that came to be dealt with and to be heavily influenced by the manuals on national accounts, or other accounting materials.¹ In the legislatures, too, there was a feeling that it was a technical matter best left to specialists.²

The reforms in the budgetary structure achieved much. Although there are some parts of the globe where considerable progress has been achieved, there are many others where much remains to be done. This chapter deals with the changes that have been made, the issues encountered, and those that remain. The approach of the chapter is an eclectic combination of the normative and positive aspects. While there is no community where a budget has yet to be introduced for the first time, the normative aspect deals with the desirable features of a relevant system and provides a reference point for assessing classification practices. The positive aspects are more concerned with actual developments and their problems.


²Writing about the United States, Arthur Smithies (1955) observed “public comprehension of the budget is greatly hampered in its bewildering terminology. On the expenditure side, the terms of appropriation, obligation, and expenditure cannot be avoided and are confusing enough” (p. 191). It was his view that the “immediate complexity” was largely the result of attempts at concealment.
CURRENT AND CAPITAL BUDGETS

The most important distinction in the budget structure is between current and capital transactions. The idea of separating the budget into two sections, in which the current budget—covering current expenditure—is to be financed, in principle, by taxation, and the capital budget—covering the acquisition of newly produced assets in the economy—is to be financed by borrowing, gained acceptance in the late 1930s. Since then this issue has become controversial, gaining over the years both strong supporters and opponents. Since the introduction of this distinction, several variants have been introduced such as recurring and nonrecurring, ordinary and extraordinary, revenue and capital, current and capital, current and investment, above and below the line, and development budgets. Implementation of development plans led to a frequent association of investment components with the capital budget, and there is a view that such a separate identification facilitates the formulation of plans and fiscal policy. The variations illustrate the great diversity of budget structures and the existence of many types of double budgets, and they make formidable the task of providing a common definition that captures the nuances of these structures. The approaches of national accounts systems or recent experiences do not ease the situation. Some of the industrial countries that had dual budget systems abandoned them during recent years in favor of additional analytical abilities gained in the use of national accounts. At the same time, the need for having a capital budget, as an appropriate check on the spending proclivities of government, is believed necessary in the United States; many developing countries find the use of the dual budget system advantageous and beneficial, and it is not viewed as a mere legacy of the colonial system. The current discussion provides two polar positions regarding the dual budget system—as an anachronism and as an imperative of the current situation. Depending on one's background or the specific situation, a case could be made for giving up the practice or, alternatively, for strengthening and streamlining the system. This underlines the need for a detailed discussion of the nature of the current and capital budgets, the initial influences, the economic, financial, and managerial considerations for it, and the measurement issues.

The meaning of the capital budget varies in the countries where it is
in use. Broadly, it reflects, on the revenue side, proceeds from the sale of government property, or taxes that are presumed to be paid from private capital as distinct from income such as death duties and capital levies, and, where practical, in the real sense of the capital budget, depreciation allowances and proceeds from borrowing. The capital expenditure budget has two approaches—a capital expenditure budget comprising outlays on the acquisition of newly produced assets that are a part of a nation’s gross investment for the period, and a finance budget comprising depreciation allowances and acquisition of previously produced assets that do not affect the volume of production but that involved a periodic valuation of government assets. The assets may be both real or financial, the latter reflecting government lending operations and other financial assets acquired. A capital budget may also be used to denote, on the receipts side, the foreign aid received, and on the expenditure side, projects and programs that are covered by foreign aid. In a number of developing countries, capital budgets are used to reflect the plan programs and investments and their scope and operations are coterminus with development plans, even if some of those activities do not result in acquisitions of assets. Notwithstanding this divergence, the principal accepted feature of a capital budget is that it primarily consists of the proceeds of borrowing, which are then used for the acquisition of assets, leaving the net worth of government unaltered.

During the 1930s, borrowing to build assets was considered acceptable. The increase in government liabilities was matched, in the event, by an increase in assets. But the position would change, however, if the proceeds of borrowing were to be used for financing current expenditures as that would reduce net assets. Viewed in terms of net worth, a distinction became necessary between expenditures that led to the creation of assets and those that did not. As capital expenditures meant an equal and balancing increase in assets, budgetary deficits and surpluses became associated with the deficits and surpluses on the current account.

The equation of borrowing with asset-creating expenditures is derived from commercial practices. The most important way for a commercial firm to maximize its profits would be for its receipts, in addition to covering its operational expenditures, to also cover expenses representing the use of capital. The surplus on its current account would reflect its capacity to augment its net worth and is its
measure of profitability. Application of this principle to government, however, is fraught with technical and philosophical issues that are difficult to resolve. In technical terms, the application of the commercial approach to government would need the maintenance of depreciation or amortization for all assets. In turn, this would involve an enormous outlay on people and time with benefits that are, at best, doubtful. More practically, it is found that even in countries with separate capital budgets, no depreciation is made in the budget. Moreover, the assets in government have multiple uses and because their purpose is to serve as public goods that are not marketable, their valuation becomes intractable. Also, the private sector practice of allocating costs over time cannot be extended to government. In the private world, outlays on the purchase of real assets, for example, plant and equipment, are capitalized in the year in which they are acquired and are written off over the life period of that asset in the form of depreciation allowances. The phasing of these allowances over a period reduces the volatility in reporting costs and the net income of the firm. In government, the real cost cannot be passed on to future generations and when the timing, as well as the magnitudes of capital outlays, is irregular, as is true during a period of planned development, the inclusion of both capital and current outlays at the time they are incurred will complicate the problem of compiling annual costs and benefits. Moreover, capital equipment in government may have multiple uses and it is difficult to allocate costs for its various uses. Philosophically, it is argued that asset creation tends to relegate the role of government from provision of social services to a lower level and

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3 It is, however, imputed in the national accounts. But, as discussed later, this is not without conceptual difficulties.

4 In addition, there are problems relating to the valuation of art museums, roads, and battleships, see Richard Goode and Eugene A. Birnbaum (1956), p. 27.

5 In a way, depreciation allowance does not alter the basic cash position of government. It is a contra-entry in the budget shown as an expenditure on the current account and a receipt on the capital account. But the computation of the costs is difficult. The irregularity in the phasing of outlays is an additional complication. In a perfectly stable program, depreciation allowances could be equal to the new capital outlays, provided annual outlays for new capital outlays had been constant for a period of years equal to the average depreciable life of the assets, see Goode and Birnbaum (1956), p. 28. This procedure is adopted in the computation of the general government sector in the national accounts of the United States, in which the new outlay is equal to the annual depreciation.
that, in any event, asset creation by itself cannot be an adequate justification for government borrowing.\textsuperscript{6} Decisions concerning the resources over which the government seeks control are based on wider considerations. While depreciation would provide for the extension and replenishment of fixed assets and liabilities, it appears that the analogy of the private sector should not be overextended. As the Crick Committee noted three decades ago "the concept of solvency" as applied to a government defies precise definition and, in any event, should not be judged by the tests ordinarily applicable to a business undertaking.\textsuperscript{7} Notwithstanding these inherent limitations in the analogy of the private sector, the technique gained easy acceptance because it provided a way out of the depression and also facilitated political agreement.\textsuperscript{8}

**ECONOMIC CONSIDERATIONS**

Several economic considerations favor the dual budget system. Briefly, these are that the structure clearly shows the current and capital outlays, that it provides a clear identification of borrowing and its utilization, and that it delineates information on the actual capital formation. Implicit in the plea for the separation of current and capital outlays is the above-mentioned belief that current expenditures should be financed from taxation and that surpluses thereon should be used, together with borrowing, for financing capital outlays. This has contributed to the emergence of the balance on the current account as a key variable in economic policy. As noted earlier, the attitude that loan funds are less acceptable for current expenditures has led to the adoption of a more stringent approach toward their review and inclusion in the budget. Some contend that the use of current balance as an indicator of development or tax effort has become a theology, and that in the process, the larger purposes of the budget have come to be neglected. For example, from the stabilization point of view, it is the

\textsuperscript{6}United Nations, *Budgetary Structure and Classification of Accounts* (1951), p. 12. In the early stages, however, dual budgets were evolved, even if not entirely convincingly, to serve as a rationalization from government borrowing; see also Jesse Burkhead (1956), p. 182.


\textsuperscript{8}The United States, which adopted the New Deal policies, did not use the technique of capital budgets.
size of the overall deficit and the pattern of its financing that are far more important. Similarly, it is suggested that the application of the current account system on the same basis as an operating surplus in a commercial firm might imply that a deficit on the current account was due to extravagance or wasteful expenditure. It may thus introduce biases in the allocation of resources. Further, the existence of two budgets and the appearance of a balance in them might pose a psychological barrier to adequate taxation during periods of inflation. Various considerations discussed earlier suggest that the need for capital budget should be seen not merely as a rationalization of borrowing but, in the wider context of the formulation of fiscal policy, in terms of overall expenditures and the appropriate mix of taxation and borrowing relevant for the purpose. Expenditures should be subjected to broader rests rather than rushing to facile conclusions that expenditures on the current account do not contribute to the development of the national product. It could also be argued that some of these contentions are based on exaggerated fears on the use of the distinction and that, within limits, the dual budget system offers a rule of thumb or a first approximation. It is only when the system goes beyond a certain stage and becomes an obsession that some of the ill effects are generated. The capital budget has the inherent feature of ensuring outlays that are financed by loans yielding a return higher than the cost of raising them. From a managerial point of view, capital budgets so organized force the decision maker to evaluate the prospective returns and recognize implicitly the capital shortage and the need for its apportionment to obtain the highest returns. The capital budget enables a better determination of the responsibility within government and provides an implicit separation of funds, phased over a period, to be spent on a project. The critics of the dual budget system argue that the need for a return, either in the limited financial sense or in the broader context of the social return, is a view that needs to be applied over a wider spectrum of public expenditure and not confined to capital budget only. Also, borrowing-spending can always be more expansionary than taxation-spending, and persistence of high government borrowing may reduce the funds available for private investment and contribute to raising the interest rates.

As for providing information on capital formation in the government sector, those who favor a budget without these distinctions suggest that the required information should more appropriately be
compiled on a supplementary basis rather than on a separation of the budget.\textsuperscript{9} Indeed, such calculations are made as a part of the periodic reports on national income. But then it could be argued that the existence of capital budget (properly organized in terms of the national income accounts), while not a prerequisite, will facilitate the quick compilation of national accounts. During the period when national income accounts are still being refined, as is happening in several developing countries, such a separately organized capital budget may prove a valuable asset. In industrial countries, where national income accounts are forecast and published regularly, the need for such a budget may be less keenly felt.

\textbf{MEASUREMENT ISSUES}

The matter of the choice between dual budgets and a unitary budget is also influenced by the more practical considerations relating to the criteria to be used to determine items for inclusion in the current and capital budgets. The formulation of the criteria, however, has been a matter of as yet unresolved dispute, which again illustrates the difficulty in evolving economic principles for daily application. As borrowed funds are the primary means of financing the capital budget, it is natural that an important criterion should be the productivity or the revenue producing capability of the proposed expenditures. Outlays have been classified, for this purpose, into "self-liquidating," covering those projects that provide an adequate revenue feedback for paying interest as well as the repayment of the principal, and "self-financing" projects consisting of those that can only pay interest charges. The application of this principle to government operations is rendered difficult, partly because revenue receipts form a part of the general pool and partly because most expenditures at the central government level are in the form of transfers to other levels of government and assets, if any, may be created there.\textsuperscript{10} Also, while

\textsuperscript{9}The President's Commission on Budget Concepts argued for depreciation and other financial statements at enterprise and program levels, but added that "[t]his is by no means the same thing as instituting a separate capital budget, separately financed, for the Government in the aggregate" (United States, 1967a, p. 34).

\textsuperscript{10}This has frequently given rise to the suggestion that in order to facilitate the identification of the revenue feedback, these projects may be organized as autonomous public undertakings, see United Nations (1951), p. 16.
assets may be created, they may not necessarily be revenue producing or they may have an uncertain future. The creation of the asset implies an expectation of income or services but their outcome may be at an indeterminate point of time. A rigorous application of this principle may reveal that expenditures that pass this test should be small.

Yet another suggested criterion is that the classification should be done with reference to the life expectancy of the asset and assets with a life span longer than one year should be included in the capital budget. A strict application of this would result in the inclusion of too many items of daily use to be within manageable limits. It is for this purpose that a combination of the asset features and life expectancy have been used for defining the criterion for inclusion. The system of national accounts, for example, views this in terms of capital formation measured by expenditures on tangible assets—"on additions of new durable goods to the stock of fixed assets." The emphasis on tangible assets has, however, been criticized because many development activities that might increase future income may not lead to the creation of tangible assets. The approach of the national accounts system follows the traditional Keynesian lines that were mainly concerned with the stock of capital. The empirical findings of Kuznets and others have demonstrated, however, that capital accumulation per se was not too significant for the rate of growth, and a greater part of growth was to be ascribed to the increase in the use or efficiency of productive resources. Outlays on family planning, research and development, or the training of civil servants have all the innate potentials of contributing to economic growth. Such potentials are not captured in the tangible or durable goods approach of national accounts. Development economists believe to be appropriate an approach that emphasizes investment for purposes of increasing future income, regardless of tangibility. An extension of this approach is the implicit suggestion that a new set of definitions and conventions should be worked out as a part of the national accounting system. 

12 The System of National Accounts was fully cognizant of the oft-repeated demand that capital formation should include the investment of human capital (a suggestion that has been repeated since originally made by Irving Fisher and A. C. Pigou in the 1920s). The authors of the UN system observed "in the development of national accounting emphasis has been placed on the distinction between what can be observed and measured and what can only be inferred on the basis of some theory or convention," United Nations. A System of National Accounts (1968), p. 15.
The definition provided by the System of National Accounts (SNA), however, excludes expenditures on military facilities, including barracks, transportation, and equipment, from tangible assets, presumably in the belief that these outlays are not productive, that they have a high rate of obsolescence and an uncertain future. More problematic is its treatment of outlays on repairs. In terms of SNA approaches, outlays on current repair are those that keep the assets "in proper working order," while capital outlays on repairs are those that "lengthen the expected normal lifetime use of fixed assets or increase the productivity of these goods significantly" and that, in order to be classified as capital, the outlays should be "substantial." Net capital formation is derived from gross capital formation by subtracting the consumption of fixed capital, which is that part of the gross product that is required to replace fixed capital. In computing net capital formation, no consumption of fixed capital is allowed for assets of government, such as dams and roads, as outlays on their repair and maintenance are assumed to maintain the assets in their original condition.

There are several problems in the measurement of capital items in terms of national accounting concepts. Apart from the conceptual difficulty associated with the narrow scope of tangible assets, the one-year longevity consideration would contribute to discrepancies, if rigidly adhered to, between quarterly and annual accounts. The distinction between repair and maintenance is arbitrary and, in the last analysis, would imply substituting the judgment of the national accounting statistician for that of the budgeteer. The measurement becomes more difficult in a context of uneven application of the criteria.

The issue is frequently raised whether capital budget is developmental or whether the development budget is a capital budget. This has

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13It could be argued that the indirect benefits of military outlays could contribute to growth and some of them should be included in the capital account. In Sweden, during the early years of experience with capital budget revenue producing assets (for example, military housing) were included in the capital budget, see United Nations, Budgeetary Structure and Classification of Accounts (1951), p. 17.

14Ibid., p. 113.

15The "saving" computed from the application of the above criteria is different from the current account surplus or deficit discussed earlier. Saving is a balancing item in the national income accounts, see United Nations, A System of National Accounts (1968), p. 130.
arisen because, as pointed out earlier, these terms have sometimes been used interchangeably and also because a major part of development outlays are met from the capital budget. Development outlays are clearly much broader and ideally would include several elements of capital expenditures and expenditures on the development of human beings and related matters. The capital budget is narrower and inclusion of items in that part of the budget is not necessarily in terms of their development character. Moreover, development outlays as a concept is rather amorphous and ambiguous. It is hard, therefore, to draw demarcation lines between these expenditures. Much is dependent on the time element, for what is developmental today might be a capital asset tomorrow.  

COUNTRY EXPERIENCES

The implementation of capital budget reveals several approaches that can be illustrated from the experiences of the United Kingdom, Sweden, the United States, and India. In the United Kingdom there was no formal capital budget but, in the presentation of exchequer accounts, a distinction was made between “above-the-line” and “below-the-line” items. The former consisted predominantly of current outlays and the latter comprised payments for which the Treasury had power to borrow. The absence of definite criteria complicated matters and in presenting the budget for 1948–49, the Chancellor recognized that some capital items were being charged to the revenue side and that the meaning or the significance of the emerging deficit or surplus was far from clear.  

For a better understanding of the situation, however, an alternative classification in the form of analytical statements was appended to the annual budget. The purpose of these statements was to facilitate economic analysis rather than for administrative convenience, while the conventional distinction of below the

16For purposes of its analytical studies, India adopts the distinction between development and nondevelopment outlays. The former includes outlays on social and community services and economic services, and the latter includes collection of taxes, audit, administrative services, and defense. In Bangladesh and Pakistan, as well, the nomenclature of development expenditures is used in the budget analytical documents and includes both recurrent and capital outlays.

17See U.K. Financial and Economic Statement, April 1948. To some extent this concern was generated by the pioneering study made by J. R. Hicks (1948).
line and above the line continued in the budget document. With the gradual development of national income concepts, the practice of supplementary alternative classification was abandoned. Finally, in implementing a wide-ranging accounting reform in 1963, it was recognized that it was preferable to focus on the preparation of economic tables that are capable of interpreting general economic developments than to become involved in the legalistic distinctions between current and capital outlays.\(^\text{18}\) Its current practice is to use the national accounting framework, and the economic classification of the budget provides an expenditure analysis of consumption expenditures and capital formation.

In Sweden the capital budget was formally introduced in 1937 as a part of the budget reform that envisaged the balancing of the budget over the business cycle, thus permitting borrowing during a depression and a budget surplus during a boom period.\(^\text{19}\) In the new budget system, only revenue producing or profitable investments were considered as assets and nonremunerative investments were written off on the current budget.\(^\text{20}\) The capital budget was primarily a listing of investment authorizations for government undertakings and funds. The current budget did not provide for annual depreciation allowances, which were provided in the respective budgets of undertakings and funds. Beginning with the draft budget for 1980/81, the dual presentation of the budget was abandoned and revenues and expenditures were presented in a single budget system.\(^\text{21}\) The capital funds maintained earlier were replaced by uniform balance sheets and, for enterprises or undertakings, the balance sheets were supplemented by profit and loss accounts for the year. The reason for giving up the dual system was that the emphasis that had been on the net worth of government had been transferred to macroeconomic aspects. The introduction of the balance sheet procedure, however, implied more of a change in the form of accounting in that assets with a minimum span of three years and above a monetary limit would be considered for capital appraisal even if they were not financed by investment appropriations hitherto included in the capital budget. Inventories and


\(^{19}\) See Bent Hansen and Leif Mutén (1958).

\(^{20}\) The write-offs were of two types—unproductive expenditures and unsettled losses.

related assets, however, would still be written off in the budget outlays.\textsuperscript{22} In a way, therefore, capital accounting continues but has ceased to be a policy tool.

In the United States there were periodic recommendations for the introduction of a capital budget\textsuperscript{23} but this never materialized, primarily because it might tilt the resource allocation in favor of "brick and mortar" projects.\textsuperscript{24} However, the budget documents present a special analysis of investment expenditures, which include outlays on "other developmental purposes," that is larger in scope than the tangible asset approach. This analysis is for information only and has no accounting or other implication for the budget structure.

In India the capital budget was introduced in 1946–47 in the context of increasing budget deficits. Separation of capital items facilitated the immediate achievement of a surplus on the revenue account. Items are included in the capital account for two reasons—longevity of assets and size of outlays. The productivity criterion is not applied nor is any depreciation considered. Over the years a case law has been evolved to provide an operational guide for inclusion of items in either budget.\textsuperscript{25}

\textbf{Problems: Alternatives}

The lack of a settled view on what constitutes capital has contributed to the emergence of a variety of practices. Three main problems are experienced. First, a multiplicity of budget categories that extend beyond the current and capital divisions has developed. Second, comprehensive criteria are rarely articulated for the classification of revenues and expenditures. Third, there is a lack of consistency in the application of the criteria. Thus, terminological confusion has arisen, which in turn generates issues in the compilation of accounts.

\textsuperscript{23}See Jesse Burkhead (1956), Chap. 8. The Hoover Commission, for example, recommended the introduction of a capital budget. For an extended discussion, see Seymour E. Harris (1963).
\textsuperscript{24}This view does not reflect well on the capabilities of budgeteers and assumes the allocative process to have little rationality about it.
\textsuperscript{25}A. Premchand (1966b), pp. 144–49. The capital budget continues to operate and major changes were made in its classification in the early 1970s, see India (1973), Vol. I, pp. 26–35.
and more significantly in policy formulation. Classification limitation prevents the government from having a clear understanding of the magnitude and composition of investment outlays and of their implications for future resources and their utilization. It may even have contributed to distortions in policymaking. These issues are serious enough to warrant a new look at the available alternatives. An idea that has gained some support since the early 1970s, following the recommendations of the U.S. President’s Commission on Budget Concepts, has been the unified budget. The recommendation had its origin in the conflicting coverages and conclusions of the administrative, cash, and national income budgets then in vogue in the United States. In considering the relevance of this approach to countries with dual budget systems, the main issue is whether the unification of budgets would avoid the conceptual problems referred to above. The need for information on capital formation, it is believed, can be met from the national accounts and the limitations of the tangible asset approach of the national accounts can be compensated for by classifying expenditures into (a) consumption, (b) investment in tangible assets, and (c) expenditure on future benefits not resulting in the acquisition of assets.26 Other limitations on the concepts of maintenance and repair could be similarly refined.

It could also be argued that the use of national accounts does not provide the managerial facility associated with capital budgets. Capital budgets meet this requirement and, notwithstanding conceptual limitations, extended practice over the years has contributed to an understanding among practitioners. For many budgeteers, the provision of funds for the budget categories is the language they understand. National accounts, while essential for policy purposes, are not the basis for allocation of funds or for recording accounts. This is not to deny the need for more improvements. The issue then is should efforts be made to improve the system by refining the classification or should it be abandoned in favor of national accounts? Answers to this are dependent on the pragmatic combination of the relative roles of economic policy and managerial considerations and the status of the national income accounts.

26For national accounts only category (b) would be relevant. For those interested in the wider developmental implications, categories (b) and (c) would be useful.
CLASSIFICATION OF REVENUES

In order of importance, the classification of revenues and expenditures follows the approaches to the dual budget and reflects, to an extent, the features pertaining to the current and capital budgets. Revenues are first divided into two categories—tax revenues reflecting the compulsory nature of the levy, and nontax revenues that are in the form of charges for services provided. The classification of revenues could be based on several premises and raises some broad questions. Should revenues be classified in terms of the legal base, for example, tax on income? or should they be classified with reference to the administrative agency responsible for their collection? To what extent can the economic effects or the final location of payments be used for classification purposes? How are capital receipts to be shown? How should proceeds from foreign aid be classified? Should the activities of the trading agencies be shown on a net or on a gross basis?

The UN System of National Accounts classified revenues into direct and indirect taxes, property income, fees, and related categories. Direct taxes are levied on individuals and others by public authorities on income from property, employment, or any other source and paid by individuals and others. Indirect taxes are assessed on producers in respect of the production, sale, or use of goods and services that are charged to the expenses of production. A major limitation of this approach, however, is that it implicitly assumes that direct taxes are paid by individuals and are not shifted forward. Present knowledge of the actual nature of incidence and shifting is not determinate. Consequently, many international and national approaches have avoided the controversy and preferred detailed itemization of revenues. Revenue categories, in practice, generally revolve around the character or legal base of the tax. Thus, taxes on income are separate from those on property, expenditure, goods and services, and international trade and transactions. In some instances, capital receipts covering the sale proceeds of fixed capital assets are also shown.27

27United Nations, A Manual for Economic and Functional Classification of Government Transactions (1958) distinguished taxes with reference to their character rather than incidence. Practices in the United Kingdom and the United States, as well as in a number of developing countries, reveal that itemization is preferred to the classification of direct and indirect taxes.

28For a fuller identification of the categories, see International Monetary Fund (1974), pp. 159–61.
These categories provide for a good deal of disaggregated detail and can be used as building blocks to analyze the economic or administrative aspects. In general, however, it is observed that the approaches to revenue classifications reveal some common features noted here. First, because of the widely differing bases (regardless of the classification), some categories present problems by having features that make them eligible for inclusion in more than one category and thus an arbitrary judgment has to be made about their final location. Second, the classification should reflect the importance of specific sources of revenue. For example, taxes on income or on domestic transactions may have no place in the budgets of oil producing and exporting countries. These sources are important in other countries—and the respective classifications indicate the relative place of the major sources of revenue. Third, the classification of revenues may more often reveal their base rather than the administrative agency responsible for their collection. In some countries this is resolved by indicating the groups of taxes (with reference to their base) under the concerned administrative agency (for example, in some countries the Commissioner of Revenue could also be responsible for the collection of customs duties).

A frequently encountered issue relates to the treatment of trading or enterprise activities in the revenue budget. Those arguing in favor of gross presentation of their activities suggest that this will better indicate the aggregate value placed on the services provided by their organization, that netting conceals the factors that have an important economic significance, and that netting tends to understate the total size of the budget relative to the national economy.\(^29\) It is evident, however, that gross presentation tends to overstate receipts (not all of which accrue finally as revenues) and that such inclusion may impose unnecessary rigidities on the operations of the enterprise. As for macroeconomic policy the size of the surplus or deficit remains the same in either event.

The treatment of foreign aid has been more complex reflecting the wide varieties and forms of aid. Aid is often given in kind and may not enter the budget ordinarily. Most countries receiving aid have developed a tradition of showing in their budget the monetary

\(^{29}\)See, for example, United States, *The Federal Budget as an Economic Document* (1962).
equivalent of the aid received for purposes of accountability.\textsuperscript{30} This
includes the valuation of bilateral and multilateral aid and suppliers' 
credits. A distinction is made between grants and loans in all these 
spheres and generally only grants are shown in revenues.\textsuperscript{31}

**CLASSIFICATION OF EXPENDITURES**

The purposes of expenditure classification have grown over the years 
and have generally kept pace with the growth and increasing 
complexity of public expenditures. Moving from accountability to 
management and to planning, classifications were improved for several 
reasons. The need for uniformity in the structures and better 
synchronization with other classifications, on one hand, and the 
introduction of program budgeting, on the other, have contributed to 
major changes in the classification of expenditures.

Expenditures were originally classified in terms of organizations and 
the objects of expenditure, i.e., the goods and services bought by 
appropriated funds. Their primary purpose was to provide a basis for 
fund requests and for controlling operations. Since then, budgets have 
moved a long way and terms such as functional, program, and activity 
classifications have become commonplace. Although there was a 
considerable debate about the virtues of each system and the 
superiority of one over the other,\textsuperscript{32} there is now greater acceptance of 
these classifications, notwithstanding varying use of the terms. Behind 
these developments, however, are a series of efforts both national and 
international to improve budget structures, the impetus for which 
came from the experience of the United States with program 
budgeting systems, and the growth of national accounting systems. 
These developments, which spanned a period of three decades, may 
best be analyzed in terms of the experience of the 1950s and the 1960s.

\textsuperscript{30} The valuation of aid presents accounting problems. For example, should food aid 
be valued at the prices prevalent in the exporting country, the importing country, or 
at an international price level? What exchange rate should be used? Economists would 
argue in favor of a rate that shows the scarcity value. Accountants appear to prefer 
more solid approaches.

\textsuperscript{31} There are several exceptions to this, however.

\textsuperscript{32} To some extent, the debate continues in some quarters. See, for example, Aaron 
Wildavsky (1979), pp. 61–78. Wildavsky's principal concern is with the approaches 
to traditional budgeting rather than with the structure of the budget.
DEVELOPMENTS DURING 1950s

The major break from the traditional or the line-item budget came in the late 1940s and early 1950s with the implementation of the recommendations of the First Hoover Commission in the United States, which recommended the refashioning of the budget by classifying government transactions into functions, activities, and projects. The emphasis in the new system was that the budget should be structured to serve as a basis for the review of accomplishments. Accordingly, the U.S. Budget and Accounting Procedures Act of 1950 provided for a budget based on the functions and activities of government. Proposals for requests for funds were formulated in terms of programs, their objectwise classification, and sources of financing. The object classification (e.g., wages), which was the bulwark of the line-item budget, continued but was used as a secondary classification. It was also envisaged that there would be complete synchronization of organizational structures and budget classifications. If the new budget presentation constituted a significant improvement, its implementation revealed some nagging problems. Should the classification be evolved with reference to the character or the objectives of programs or should the organizational structure continue to dominate?33 The contemporary experience was that the practical world did not lend itself to neat and discrete categories as required under the new approaches. In practice, classifications were either too broad or too narrow to reveal significant activities or to provide a comprehensive overview facilitating the annual budgetary decision making. There was also the fear that, in the process of evolving the new classification, management considerations were not given their due. This experience was reviewed by the Second Hoover Commission in 1955, which reiterated the submission of the budget to be based on functions, activities, and projects and suggested that further steps be taken to synchronize the “organization structures, budget classifications, and accounting systems.” This approach to the classification of expenditure has continued since then, although further refinements were made during the 1960s.

33 Adherence to organizational structure implied that different programs could be run by different agencies for meeting the same objectives and their interrelationships would be lost in the program overlap; to that extent, a major purpose of classification would be in jeopardy.
Meanwhile, the data requirements of economic and social policies for development purposes were becoming clearer and the recognition that most governments provide common services led to the identification of functional categories that could be used with variation by countries. If the classification of the budget were to serve as a reliable instrument for policymaking, it should be capable of indicating the purposes achieved and incidence of burdens and benefits of government expenditure. In particular, the classification should facilitate priority planning and decision making on the desirability of spending more or less on a particular service. The result of this recognition was the UN publication of *A Manual for Economic and Functional Classification of Government Transactions* (1958). The Manual divided government functions into 15 functions and grouped them into 5 major clusters—General Services, Defense, Social and Community Services, Economic Services, and unallocable expenditure. The Manual also provided an economic classification that, in conjunction with functional classification, would serve policy purposes. The Manual was discussed and refined in a series of international meetings during 1957–64 and won a substantial following in a number of countries. The implementation itself, however, reveals a mixed picture. The Manual provided an enlightened understanding of the inadequacies of the traditional budget but its functional categorization was too aggregative to adequately serve policy requirements and most governments used it as a supplementary analytical table to show the disposition of expenditures rather than for operational purposes for budget making.

**Refinements During 1960s**

The introduction of the functional and program classifications in the United States in the 1950s very soon proved to be less than adequate for the growing requirements of budget management. By the mid-1960s, it was felt that the budget should measure money costs for achieving a program objective, should facilitate the comparison of alternatives and future cost implications, and should generate the economic data needed for policymaking. The budget structure, it was felt, continued to be a comptroller's one rather than one oriented to managerial or economic purposes. It did not help to clarify the relationship between the financial and physical aspects or the
relationship of one budget function with another. At an operational level, the terms "program, performance, activity, and function" were all used more or less interchangeably and there was no consistent understanding of program categories. The avoidance of these problems became the primary objective of the planning, programming, and budgeting systems introduced throughout the federal government in 1965. Specifically, it was felt that the program structure should be so devised as to provide a framework defining far more clearly alternative choices to be made and an information system to assist in measuring costs in relation to accomplishments. The programs, therefore, were to be classified in order to allow a cost-benefit analysis.

The translation of these ideas into budget routines took time and were refined over a three-year period. First, it was recognized that the new budget classification should adhere to the character of the activity and would therefore be different from the prevailing organizational structure. Later, it was recognized that program categories should provide an appropriate framework for policy consideration for each agency and that each agency was responsible for formulating its own program structure and thus a link was sought with organizational structures. In its final phase, still caught between the conflicting claims of organizational responsibility and the broader purposes of policy formulation, the instructions noted that program structure "must cut across organization lines, appropriations, and other classifications." But as "pursuit of absolute uniformity and consistency in development of a program structure will, however, be counterproductive," it was decided that the Bureau of the Budget "will continue to work toward development of a government-wide program structure." The development of such a classification of budget expenditures was, however, only partially successful. The classifications developed by agencies differed widely in quality and usefulness. The new

34 For an interesting enumeration of these defects of the traditional budget, see David Novick (1965), pp. 5, 11, 13, 19, 35, and 43.
classifications did not form a basis for decision making, which continued to revolve around the appropriation structure of the budget, i.e., object classification. The efforts were not, however, without benefits as, in some cases, they opened up productive lines of inquiry.

The overall emphasis on improved classification also found expression in the United Nation’s *A Manual for Programme and Performance Budgeting* (1965b) and *A System of National Accounts (SNA)* (1968). The former outlined the approaches that formed part of the performance and planning, programming, budgeting systems introduced in the United States. The System of National Accounts took a broader view and its classification of government activities, while being consistent with the International Standard Industrial Classification for all economic activities, was evolved to show separately (a) the services intended for the community as a whole, (b) the services to households, and (c) the services for promoting and assisting economic activity. The classification proposed in the SNA divided expenditures into nine groups (General Public Services, Defense, Education, Health, Social Security and Welfare Services, Housing and Community Services, Other Community and Social Services, Economic Services, and other purposes) and subdivided these into categories that were equivalent to programs, to permit a better measure of the costs. These categories have been clearly influenced by the principles of classification of planning, programming, and budgeting systems.

**Content of Classification**

The classification of expenditures now involves the division of government transactions into categories that would serve the accumulated purposes of the previous three decades. Basically, it involves the formulation of functions, programs, activities, and cost elements. The function is a major division of government and its purpose is to provide a distinct and public service. It may be administered by several agencies but the aggregation would show the linkages with other services and would permit a better comprehension of the aggregate objectives of expenditures. This planning function will have to be supplemented by the management function, as categories will have to indicate their organizational responsibilities.
Ideally, a congruence between organizations and functions would be desirable. In reality, however, it is different. A classification system does not warrant a reorganization of the government but will have to be dovetailed to the existing structure. This has been done in practice in each case to reflect a combination of aggregative and organizational features. Also, there are some functions, for example, public debt, that do not lend themselves to organizational apportionment and are, therefore, best maintained as separate functions.

The functions are subdivided into programs that are technically viewed as segments of functions with major end objectives. Preferably, they should be adaptable to cost-benefit analysis treatment, compilation of accounts, and computation of costs. Two conflicts that emerged in evolving these programs were in relating them to the agencies, as distinguished from the transactions of the government as a whole, and in according the necessary priority for the application of cost-benefit analysis. In practice, programs are largely evolved within the parameters of an agency, and where considerations of cost-benefit analysis and its implications for the program structure conflict with other factors, separate and generally more specific programs are formulated for cost-benefit analysis. The programs are further subdivided into homogeneous categories of activities, each of which is divided, in turn, into cost elements that correspond to the line items of the conventional budget. In its pure form there is congruence between budget structures and the organizational form of government as illustrated in Tables 18 and 19.

**Table 18. Budget Structure and Government Organization**

<table>
<thead>
<tr>
<th>Structure</th>
<th>Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Function</td>
<td>Ministry or department</td>
</tr>
<tr>
<td>Program</td>
<td>Bureaus, directorates, etc.</td>
</tr>
<tr>
<td>Activity</td>
<td>Field agencies or divisions of bureaus</td>
</tr>
</tbody>
</table>

The budget structure discussed above has the inherent potential of meeting the accountability requirements (elements of expense), planning requirements (programs and activities), and operational and
managerial requirements (programs and cost elements). In addition, it also eliminates current and capital classification and permits a composite view of the programs.

ECONOMIC CLASSIFICATION OF EXPENDITURES

The performance and program budgeting systems have mostly emphasized the planning and policy requirements of the budgets. As the operations of government grew, attention also had to be focused on measuring the impact of the government budget. To achieve this objective expenditures are classified in economic categories as envisaged by the UN System of National Accounts—consumption, subsidies, transfers, and capital formation. These categories, while useful in providing an aggregate picture of the national economy, need additional details to be useful in policymaking. The components of
wages and salaries, transactions within the domestic economy and with the external sector, types of transfers and the prospective recipients, categories of capital formation (existing or new assets—financial or physical—additions to stocks) require to be provided in greater detail. In a way, the traditional line-item budget provides a nucleus for the economic classification through its specification of the objects of expenditure but it does not fully anticipate the requirements of economic policymaking. This task was carried forward in the UN Manual for Economic and Functional Classification of Government Transactions and was further refined in the IMF Manual on Government Finance Statistics. Most government budgets now have an economic classification, although the extent of detail varies among them.39

CLASSIFICATION OF FINANCING

The growth of budget deficits made more urgent the need for a clearer delineation of the methods of financing deficits. This effort received further stimulus from another source; the coordination of fiscal and monetary policies require a comprehensible estimation of the sources and magnitudes of financing the budget deficit. Financing transactions are examined from two angles: (a) the instrument of indebtedness and (b) the potential holder of the debt instrument. Provision of further details in this regard in budget documents is vitiated by the fact that governments are reluctant to reveal their full borrowing plans and specify them in chosen budget categories. More often they announce the extent of the deficit and the amount of foreign loans that would be received and imply that the gap is to be financed by short- or long-term borrowing from the domestic sector. In developing countries, the issue of debt is dealt with in close consultation with the central banks, and the choice between short- and long-term securities and the potential holders depend on the market

39In the early years, economic classification was undertaken as a supplementary exercise by the central banks in their annual review of government finances. Later, with the ascendancy of economic considerations, economic classification of expenditures was presented as an analytical table and was shown separately in the budget document for information purposes. During the 1970s, however, with greater importance on the assessment of the economic impact, many countries introduced economic classification of expenditures in the main budget documents.
situation and the attractiveness of government securities in relation to private sector debentures. Where there are no developed capital markets, the debt issued by government may be taken, as noted earlier, in its entirety by the central bank itself. As these arrangements are partly confidential and also because of uncertainty, firm budget estimates by holders are not indicated. More information is provided for previous years on the type of the debt instrument and the holder. In countries where the entire issue of debt may be financed by the proceeds from the captive funds (e.g., pension funds), which are also managed by governments, the details of these transactions may be shown in the budget documents. In practice, the use of detailed classification of the sources of financing is limited to a presentation of data for the past, while for the future, budgets show only broad aggregates for domestic and foreign borrowing.

IMPLEMENTATION: SOME EXPERIENCES

The growth of improved classifications soon became popular and over the years several governments have made efforts to introduce revised classifications. Among the developing countries that have introduced major changes in their budgetary structures are the following: in Asia—India, Korea, Malaysia, Nepal, the Philippines, Sri Lanka, and Thailand; in the Caribbean—Barbados, Guyana, and Jamaica; in Africa—Burundi, Egypt, Ghana, Malawi, South Africa, and Tanzania; and in Latin America—Argentina, Chile, Mexico, Colombia, and Costa Rica. Austria, France, the Federal Republic of Germany, Greece, the Netherlands, Portugal, Sweden, and the United Kingdom are the industrial countries that have undertaken changes in their budget structures. These changes were part of the reforms that revealed three different approaches. In industrial countries the reform followed the tradition of national accounts and reflected the desire to ensure a greater degree of synchronization between budget structures

40Bangladesh and Pakistan are among those that continue the inherited budget structures. In both countries, the budgets are largely based on the system that was introduced in composite India in 1935. Since then some minor changes have been made in the budget structure to accommodate the changes in the respective Constitutions.

41Japan has not made any changes in its budget structure. Increased use has, however, been made of national accounts.
and national accounts. In the developing countries the reform was, to a major extent, undertaken as part of the introduction of performance and program budgeting systems. In some French-speaking African countries the improvements were largely influenced by the General Accounting Plan (which also aimed at coordination with national accounts) that had been introduced in France. The philosophy behind the introduction of these improvements was in a progressive direction, as this enabled the budget structures to keep up with other developments in the economy.

The implementation of reforms in the budget structure reveals some aspects that emphasize the need for further attention. First, the introduction of reforms has been problematic. In some countries there was opposition from the legislature to the revised structures, under the impression that the shift from object classification would erode the traditional legislative control over appropriations. Adjustment to the legislative wishes contributed to truncated reforms, with reliance partly on previous structures and partly on new structures. Second, the form of the revised budget structures themselves in several countries left a lot to be desired. There are far too many ill-defined items. Lack of standardization is a common handicap. Programs often do not show the cost elements. The classification itself often is an amorphous collection of organizations, objects, and programs thrown together to form a potpourri that would somehow sort itself out. Also, there is a feeling that improved budget structures, once developed would be appropriate for all future years and there has been little improvement in program classifications, which have clearly been overtaken by time and events. Third, reforms have often been introduced without the necessary administrative preparation and with a lack of detailed phasing plans that aggravated some of the difficulties. Fourth, because of the weaknesses enumerated above, the structures failed to achieve some of the major objectives of the classifications. Available evidence does not suggest that either cost compilation or the facility to apply

42The introduction of performance classification in the United States, although it was undertaken ostensibly to improve the legislative understanding of the budget, did not become the basis of annual budgetary legislation. In the Philippines, the budget classification was improved but the basic structure of the budget with five accounts was retained. In Nepal, when a substantially abridged version of the object classification was introduced, it had to be withdrawn in less than a day because of severe opposition from the legislature. For an account of the Nepalese experience, see John C. Beyer (1973).
quantitative techniques has been achieved. Meeting these diverse tasks appears to need greater detail in the budget structure. Fifth, the requirements of budget policymaking have not also been fully met because of the fact that needed changes in the supplemental accounting systems were not made. This again prevented the full utilization of the budget structures and, finally, pending the improvement in the budget structures, more reliance had to be placed on national income data and as these were not well-developed in developing countries, policymaking continued to be conjectural rather than factual.

SOCIAL SECURITY

The issue relating to social security insofar as budget structure is concerned is not one of classification but of treatment. Is the contribution to social security a tax to be included as a separate category in revenues? or is it a contribution that is held in trust by the government and is, therefore, to be shown as a source of borrowing? The implications of the treatment are obvious in that the former may obscure a deficit and the latter could accentuate it. The answer is dependent on the type of social security system prevalent in a country.

Definitions of social security systems are generally avoided, in view of the great variety of services and programs that contribute to the social security system and also in view of the varying concepts and methods used in different countries. Two considerations have been proposed for the determination of a social security system—(a) the objective of the system must be to grant medical care or maintain income in the event of loss of earnings and (b) the system must have been set up by legislation attributing the power of administration to a public body. Following these criteria, the system is considered to consist of compulsory social insurance, certain voluntary social insurance schemes, family allowance schemes, special schemes for public employees, public health services, and public assistance and benefits granted to war victims. Within this sphere, three major approaches, each commonly regarded as a form of social security, are discerned: social insurance, public service, and social assistance.

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44 See United States, Social Security Administration, Social Security Programs Throughout the World (annual, Washington, various issues).
social insurance program, the most common form of social security, is generally financed by contributions from employers and employees, is operated as a separate authority, and benefits that are linked to contributions or coverage are paid from the fund. Public service primarily consists of the direct provision of a service or a cash payment from the general budgetary funds to members of the community who are within a defined category. Usually, payment of pensions, maternity grants, and family allowances are covered under this approach. Benefits under this program do not have any bias toward contributions and are not covered by social insurance programs. The third approach of social assistance consists of payments that are also made from the budget to recipients whose financial status is subject to investigation in order to determine the need and the amount of assistance they receive. Old-age and unemployment assistance are covered by this approach. In addition, there are quasi-social security measures that include provident fund systems, which are prevalent in many Asian countries. These funds comprise contributions by employers and employees and are paid with interest in the event of a contingency, for example, old age, invalidity, or death.

The integration of the social security system with government budget is suggested for several reasons. First, social insurance contributions represent a kind of wage tax and benefit payments are not distinguishable from expenditures for similar purposes; second, the motivation of government-regulated insurance is different from private insurance; third, the inclusion of social security contributions is important for measuring the economic impact of the budget; and fourth, these programs are imposed, controlled, and financed to a large extent by general revenues and should, therefore, appropriately be considered as part of the budget.

The other view is that, although contributions by employers and employees can be altered, depending on the fiscal policy requirements, in lieu of income taxes, they differ from taxes in that there is a direct quid pro quo and services are provided in relation to the rates of contribution. The rights of individuals to benefits are either derived from or in some way linked with the coverage of the program and contributions constitute deferred liabilities to the program. It is for this reason that the programs are administered separately. Inclusion of such liabilities in government budget would mask the correct financial status of the government. The purposes of economic analysis could be
met by appropriate aggregation for analytical purposes and do not necessarily require integration with the budget. This approach is followed, for example, in the United States, where social insurance is organized as a separate trust fund. For purposes of calculating the effect of federal government activities on the level of income and employment in the country, the flows of the fund are taken into account. At the same time, there is also separate trust fund accounting and the investment of surplus funds in government securities is shown separately.

On balance, therefore, the treatment of social security depends on the nature of the program, its financial status, and the approaches to economic analysis.⁴⁵

⁴⁵ For purposes of national accounting, however, social security transactions are included in the general government sector. When social security is administered separately, it implies that employer and employee contributions can be used only to finance benefit payments and therefore cannot be considered as a part of general revenues.
CHAPTER ELEVEN

Budget Innovations: Performance to Zero-Base Budgeting Systems

History has many cunning passages, contrived corridors
And issues, deceives with whispering ambitions,
Guides us by vanities.
T. S. ELIOT. Gerontion

It is a truism that budgetary reform¹ bears the imprint of the age and reflects the needs of the period. In fact, problems may be better identified when the material conditions for their solution already exist. Budget innovations cover a wide area and are frequently considered as synonymous with such far-reaching matters as strengthening administrative processes, achieving more effective or more stringent financial controls, ensuring efficiency, and economy, and better utilization of resources, controlling inflation, and improving legislative accountability or the public's understanding of the budget. Some of these aspects have been considered previously. This chapter is concerned with the structural aspects of major budget reforms, the factors leading to the reforms, the manner of their implementation, and their implications for the future. It should be noted at the outset that the new systems have gained some support over the years, as well as severe criticism. If the critics are to be believed, there was no novelty in the systems or, alternatively, they were too ambitious to succeed at any time. Supporters usually found only virtues in the systems advocated and believed that most problems lay in implementation. The course of

¹The term “reform” has extensive connotations. Its use here broadly follows the Webster Dictionary, which defines the act of reform as one of amendment or improvement or removal of faults or abuses.
reforms and their success or failure convey, to a great extent, the economic environment in which budgets have to function and the problems that are inherent in transforming well-conceived strategies of reform into practical budget routines.

**EARLY REFORMS**

Budget reforms in specific areas were noted in previous chapters. To recapitulate briefly, reforms in the early nineteenth century were primarily initiated to provide greater accountability. Early efforts in the United Kingdom, France, and elsewhere were aimed at providing a meaningful and operational framework for accountability and the basic features of these systems continued without any major upheavals into the 1920s.

The problems of the 1920s stemmed from the excessive influence exerted by the central agency in the British type of system, while in the United States the difficulty was one of formulating a budget—a responsibility that belonged to the legislature but one that proved difficult to accomplish. Budget reforms, therefore, sought to delegate greater financial powers to the spending departments in the United Kingdom and to the development of budgetary responsibilities in the executive branch, in the United States. A beginning was made with the decentralization of financial powers in the United Kingdom and a framework of coordinated financial working between the central and spending departments began to emerge. This framework and the associated budget system proved viable for several years, but as expenditure grew rapidly, the issue of legislative control and what it could do to stem the growth of expenditures became matters of concern. If the early history of legislative control over the purse of the nation reveals continuing efforts to acquire greater power over the expenditures of the monarch, the budget reforms since World War II suggest that the main attention was not on the exercise of legislative power but on the problems emerging therefrom—in particular, the growth of expenditures that were approved by the legislature. The recognition of the problem, viz., the growth of expenditures, has remained; but the problem's manifestations have changed. It was viewed in the 1950s as declining legislative accountability, in the 1960s as a problem of allocative efficiency, and in the 1970s as a problem of inflation and increasing public sector activities. The first
major response to new problems and budgetary reforms came to be formally undertaken in the early 1950s in the United States in the form of performance budgeting. The conceptual framework of performance budgeting underwent some refinements during the 1960s and various forms of it are now in operation both in industrial and in developing countries. There are, however, different interpretations of the system and its components, all of which have contributed to avoidable semantic confusion. It is, therefore, in order to consider in some detail the background and features of this system.

**Performance Budgeting**

The problems of controlling public expenditure and restoring legislative control of the government budget prompted the first Hoover Commission to raise two basic questions: (1) What is the desirable magnitude of expenditure on any major government program? and the desirable proportion of total expenditure to the gross national product? and (2) how efficiently and economically can an approved program be executed? or can the same amount of work be performed satisfactorily through other arrangements or through improved procedures at less cost? In providing answers to these questions, the Hoover Commission was influenced by the techniques of performance budgeting that were prevalent for a number of years in the county and metropolitan governments of the United States and that were sporadically experimented with in some of the U.S. Federal Government departments. The Hoover Commission recommended the introduction of performance budgeting throughout the Federal Government. Although the recommendations of the Commission were not followed completely, they did have an impact in that the Budget and Accounting Procedures Act, 1950 provided for a federal budget based on the functions and activities of the Government.

The performance budget envisaged by the Hoover Commission consisted of three elements (a) program and activity classification of

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3. For a detailed account of the experience of performance budgeting in municipal and county government and in the Tennessee Valley Authority, see Jesse Burkhead (1956), Chap. 7.
government transactions, (b) performance measurements, and (c) performance reporting. The details of the first aspect were considered in the previous chapter; the concern here is with the other elements. Performance measurement, which was derived from cost accounting and the approaches of scientific management, provided a basis for the use of manpower and other factors of production, the costs of such uses, the effectiveness with which they are used, and the accomplishments made in the process. Its approach was to relate the purpose of doing something with the cost.\textsuperscript{4} Performance measurements implied the specification of yardsticks for efficiency that could be in terms of predetermined standards, or performance over a period of time, or in comparison with similar other organizations. It was recognized, however, that not all activities of government would have parallel situations, nor would the measurement of productivity in government be an easy task.\textsuperscript{5}

The performance budget was so structured that it provided a descriptive account of the tasks and work plan for each department. In support of the outlays, descriptions of the programs are given with productivity measurements, workload data, and intended goals or accomplishments. It was hoped that such a presentation would shift the focus of budgetary review from the inputs to the consideration of performance-oriented programs. The implementation of this approach, however, ran into difficulties. It required advance programming, the classification of government transactions into programs, measurement of costs and productivity, and the acceptance of a specific responsibility by agencies. There was an implicit belief that with the introduction of a managerial system in which managers were allowed to manage, as in the commercial world, and, if appropriate yardsticks were evolved to measure their performance, problems of government financial management would be solved to a considerable extent.\textsuperscript{6} Apart from the previously noted difficulties in ensuring proper classification, the measurement of productivity in government proved elusive. Although in the initial attempt productivity measures were evolved for a few

\textsuperscript{4}This aspect of cost-based budgeting is also known as factorial budgeting.

\textsuperscript{5}For a more detailed account of these aspects, see A. Premchand (1969b).

\textsuperscript{6}This approach was later revived in Canada in 1963, and the influence of managerial practices in the commercial world is even more evident in the Canadian Report of the Royal Commission on Government Organization (GLASCO) (1963).
organizations, it quickly became apparent that service or policy-oriented agencies offered more challenges. The emphasis was shifted to the costing of operations as a proxy for the measurement of productivity. Computation of costs continued to be equally complex and did not, in any event, sufficiently reveal the qualitative differences in services. Performance budgets offered a better quantitative basis but decision making had to consider the qualitative aspects too, and it appeared that reliance on the former alone could lead to erroneous conclusions. Difficulties were also encountered in reorienting the approaches of practitioners and legislators. Lack of substantial educational effort and phasing of implementation contributed to more problems. These were reviewed by the Second Hoover Commission in 1955, which reiterated its recommendations for program classification in government and for a budget “that was formulated and administered on a cost basis”; it noted that only some elements of performance budgeting were being implemented and, in order to distinguish them from the ideal and the desirable, the Commission introduced what, in the interests of clarity, is considered to be the concept of program budgeting.

**Program Budgeting**

A question that has not so far been resolved satisfactorily is the basic difference between performance and program budgeting. The task force of the Hoover Commission considered these two terms as interchangeable, although the Commission preferred the use of the term program budget. In the immediate context of implementation, program budgeting was largely considered as a way of living with the acceptable and feasible features of performance budgeting; the emphasis of program budgeting was on classification aspects for which cost and related data could be developed over a period of years. It was, therefore, a preliminary but essential step toward the long-term goal of performance budgeting. However, there are differences between the two systems. Conceptually, program budgeting laid greater emphasis on the classification of the budget and it was, therefore, viewed to be forward looking, as "adapted to the requirements of over-all budgetary

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planning,” and as “an allocative process among competing claims.” In this view, performance budgeting was considered as a record of prior accomplishment and as a system that was more than anything else control and management oriented while program budgeting was considered as a planning device. In operational terms, however, it was difficult to envisage that the benefits of classification would stop with presentation or allocation; as a logical extension, the same process would also become a basis for assigning responsibilities. Performance budgeting emphasized the cost aspects but it would be misleading to suggest that such data would be used only for evaluation and not for allocation. In reality, evaluation is a necessary input into allocative decisions. A budget is, by definition, forward looking and it would not serve that purpose without an adequate past. The confusion about the concepts and terms was somewhat alleviated later in the UN Manual, which viewed performance budgeting as an all-inclusive concept embodying program formulation as well as the measurement of the performance of work in accomplishing program objectives.

The program budgeting system as it came to be implemented in the U.S. Federal Government departments stressed the classification aspect. Efforts were also made to improve the analysis of productivity, but its success continued to be limited. The new system very soon developed bottlenecks, some in relation to its conceptual framework and some in relation to the newly emerging needs. The approach to classification did not solve the problem of interdependence and complementarity among the agencies and their common purposes in view of the predominantly organizational orientation in the program

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8Jesse Burkhead (1956), p. 139.
10An interregional workshop organized by the United Nations noted that there were many misinterpretations of the terms. It felt, however, that the connotation of performance budgeting tended to create an initial reaction that was negative to the system as more problems were anticipated in devising and employing measures of performance. It, therefore, suggested the use of program budgeting that implied better formulation of programs and more effective results for its psychological advantage in that its content was the same as performance budgeting but appeared to be more feasible. See United Nations, Report of the Inter-Regional Workshop on Problems of Budget Classification and Management in Developing Countries (1964), pp. 112-113.
12Ibid., p. 3.
13See United States, Bureau of the Budget (1964).
structure. The programs did not, it was felt, delineate the relationship between the objective, on the one hand, and their own content, on the other, nor was there a framework within which choices could be evaluated. The budget covered only the short span of a year and was not useful enough for allocative planning. To overcome these limitations, and influenced by the pioneering work of the Rand Corporation, a variant of program budgeting, still known by that name, was introduced in the U.S. Department of Defense.

The Defense Department's budgeting system, which became operational after 1961, had three principal features: (1) A system of classification in which programs were related to a major objective of policy, were capable of being classified into a number of elements that could be substituted for each other and that lent themselves to a preferred mix, and that cut across service lines and allowed coordination among them. (2) A program analysis allowing effective and efficient ways for reaching the goal. (3) An annual budget cycle in which classification and program analysis became integral parts. Defense's system had several distinguishing features: First, its emphasis was on the application of quantitative criteria (cost effectiveness analysis, systems analysis), and second, it evolved a program structure that facilitated centralized decision making. Defense's system offered a unique combination of economic, managerial, and accounting approaches and constituted a significant attempt at applying the approaches of the commercial world to government. To that extent, it was an advancement over performance budgeting as the emphasis was now on efficiency in an operational way, as well as on efficiency in an allocative sense. A distinction was made, however, between effectiveness, which was an expression of relationship between purpose and result, and efficiency, which emphasized the resources used in achieving the result.

For a comparative analysis of the principles of military strategy and principles of business planning, see Appendix B prepared by Robert H. Caplan III in Robert N. Anthony (1965). There is considerable similarity between these two practices in matters relating to the importance of the objective, allocation of resources, flexibility, and coordination. There are, however, no business equivalents to the defense features such as offensive, surprise, and simplicity. Military approaches stress operational planning required for the execution of the strategy. In reality, however, business strategy also relies on offensive and surprise, and the growth of strategic planning implies that business is not reluctant to plan.
PLANNING, PROGRAMMING, BUDGETING SYSTEM (PPBS)

The system in the Defense Department was extended throughout the U.S. Federal Government in 1965. Introducing the system, the President claimed that it was a "very new and very revolutionary system" through which "the full promise of a finer life can be brought to every American at the lowest possible cost." Notwithstanding the claim, it was in fact a system that was in the making for a long time. Its basic elements were drawn from previous systems, but it differed from them in that it offered a paradigmatic approach to policymaking involving the specification of objectives, formulation of programs, a critical and systematic examination of alternatives, analysis over the long term, and application of quantitative techniques. Upon its introduction, the name of the system was changed from Program Budgeting to Planning, Programming, Budgeting System (PPBS).

The PPBS formulated by the government involved three levels of management.

Policy management: Identification of needs, analysis of options, selection of programs, and allocation of resources

Resource management: Establishment of basic support systems viz., improvements in basic budget structures, financial management practices

Program management: Implementation of policies and related operations; accounting, reporting, and evaluation

Stated in the above manner, however, it appears to be the general characteristics of any budgetary system, including the traditional budget. The differences are to be found both in the basic approaches.

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\(^{15}\) David Novick (1965), p. v.

\(^{16}\) This did not eliminate semantic confusion. The title of the book that was used to spread the system was Program Budgeting (Novick, 1965). His more recent work does not reduce this problem in that he equates Program Budgeting with PPBS, see David Novick (1973).

\(^{17}\) In one sense, these are comparable to strategic planning, management, and operational controls. Strategic planning is the process of deciding on objectives of the organization, while management control is the process by which managers assure the allotment of funds and their efficient use. Operational control is the process of assuring that specific tasks are carried out effectively. See Robert N. Anthony (1965), pp. 16–18.
and in the way in which they are packaged. The formulation of needs, for example, involved in the PPBS "(1) appraisals and comparisons of various government activities in terms of their contributions to national objectives, (2) determination of how given objectives can be attained with minimum expenditure of resources, (3) projection of activities over an adequate time horizon, (4) comparison of the relative contribution of private and public activities to national objectives, and (5) revisions of objectives, programs, and budgets in the light of experience and changing circumstances." Packaging was different in that these diverse elements were brought into a single system and into a unified budgetary process. In conformity with the above objectives, the PPBS had three major ingredients (a) structural aspects, dealing with the classification of government transactions, (b) analytical aspects, dealing with the application of quantitative criteria for the determination of appropriate programs, and (c) informational aspects, dealing with the development of supporting systems that help policy formulation and appraisal. The flow of these activities is illustrated in Table 20.

The operational aspects of the PPBS contained five formal elements: (1) Program structures that were required for all government activities to facilitate consideration of programs of a common nature; (2) issue letters to be sent out by the Office of Management and Budget indicating the program issues that should receive attention; (3) program memoranda showing the decisions made by agencies and the reasons for such decisions; (4) special analytical studies and the application of mathematical techniques; and (5) financial plans showing the outlays for each program, the funds committed for the next five years, and the link between annual budget allocations and medium-term plans.

**Problem Areas**

The implementation of the PPBS raised the question of the feasibility of specifying objectives and the application cost-benefit analysis for assessing alternatives. The system's emphasis on the development of information did not, however, result in any progress; the then existing financial information systems continued by and large with some refinements, particularly in the Defense Department. The
### Table 20. Schematic Presentation of the PPB System

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<th>Analytical Aspects</th>
<th>Informational Aspects</th>
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**Issues**

Issues regarding objectives and cost-benefit analysis were more fundamental, while issues on information were technical.

The contribution of the PPBS lies in the reiteration of rationality approaches to decision making, combining them with other relevant elements into an integrated budgetary framework. In order to ensure rational decision making, operationally defined goals are needed. As a basis for allocation of resources, the outputs of the proposed programs should be related to objectives. But the specification of goals is a difficult task. Politicians generally prefer to keep goals as vague as possible. Moreover, goals are in the nature of political ends and cannot be considered in terms of technical means. It should be recognized, however, that the objectives considered by the PPBS are more like intermediate steps in long causal chains between the ultimate ends and means. The final choices of goals are the prerogative of the politician but it would be too far-fetched to suggest that, in a complex economic

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18 Distinction is usually made between goals—those that are long term and objectives that are more concerned with short term. Their nature is, however, common and the terms are, therefore, used here interchangeably.
environment, the choices are totally political; there is often a substantial influence of the planner or the economist on the political process.

The goals and objectives with which the budgeteer is concerned are more tangible.\textsuperscript{19} Although there are areas in government that do not lend themselves to easy specification, there are other areas that are more amenable. The problems of objectives should preferably be discussed not in philosophical terms of their ambiguities, ambivalences, and conflicts but in more practical terms. It would then appear that the primary difficulty is that objectives tend to be diffuse, both because of their intrinsic features and for administrative convenience and, therefore, they can be nonoperational. Another difficulty arises in achieving proper trade-offs in view of the extensive, covert, or overt operation of different pressure groups.

The second criticism is that relating outputs to objectives is difficult and that consideration of direct or identifiable measures only may not reveal the magnitude of unintended effects. In service-oriented agencies such as education and health, quantitative factors are only partially helpful in assuring the objective-output relationships. This difficulty is again a practical one. Performance budgeting stressed the need for developing appropriate indicators but as everyone tended to overstate the difficulties, the effort itself got bogged down. While such initial failures should have spurred more intensive efforts (as is true in physical and chemical sciences), in fact it received less attention and, in due course, policymakers and analysts found themselves in a vicious circle. Correct policymaking needs accurate data, but accurate data cannot be generated because of conceptual and practical difficulties. The result in such circumstances is predictable and the PPBS did not prove an exception.

The application of cost-benefit analysis was essentially derived from the commercial world. The firm in the private sector appraises the alternatives and estimates the expected rate of return from proposed investments. This involves the estimation of future flows of costs and

\textsuperscript{19}Some have, however, tended to de-emphasize the problem altogether. For example, Rivlin says that "despite its elaborate terminology" PPBS is essentially a commonsense approach to decision making. In her view the PPBS is simply an attempt to institutionalize this commonsense approach in the government budgeting process; Alice M. Rivlin (1971), p. 3. This, however, is an oversimplification.
revenues and the application of a discount rate, which, when applied to these flows, gives a present value of the difference between them equal to the investment. After an assessment of the internal rates, the one with the highest rate of return is selected. The thrust of PPBS is similar, as it seeks allocative efficiency. The analytical aspect of the system consisted of the application of these techniques to the appraisal of goals and their alternative means. The conversion of this basic idea into an operational framework still bristles with problems. The essence of the analysis that actual receipts and expenditures do not fully measure the social benefits and costs, and that the approach should be to analyze the resource use rather than costs, is itself unassailable. It is not the concept—much less the need—that is controversial, but the state of the art of this technique(s). A major problem is that the analysis aims at imputing the monetary value of benefits and costs to some areas that do not have market prices. The identified and measurable benefits may be overwhelmed by those not identified. Similar questions arise on the appropriate rate of discount, on the measure of the externalities of one program to the other and on the treatment of additional incomes generated by the project. If such incomes are taken into account, it is only appropriate that incomes not generated because of tax policies are also taken into account so that the inconsistencies could be better analyzed. The system is intended for long-range planning as it permits a broad view of the side effects. But in the short run the behavior of costs could be different. For purposes of long-range planning, there is a built-in incentive for the planner to overestimate demand, but the short-run fluctuations in demand could severely impair the financial outlook of the project; these aspects are not given sufficient recognition in the analysis and, when they are recognized, compensatory technical adjustments may not be sufficient. The techniques of analysis cannot also provide answers (some suggest

20 Notwithstanding a skillful application of the technique, it is felt that the benefits that can be measured would be outweighed by those that cannot be quantified. Indeed, this would lead to a situation that would be equivalent to making a stew with a scientifically prepared rabbit and a randomly chosen horse. See Anthony Downs in Robert Dorfman (1965). It could be argued, however, that the technique would be useful in indicating the benefits that are measurable and those that are not. The important thing, as Margolis pointed out, is to extract the values relevant to the policymaker. See Margolis’s comment on page 71 in Samuel B. Chase, Jr. (1968).
that they are not intended to)\(^2^1\) to the Pigouvian question of whether more should be allocated to the construction of battleships or to relief for the poor. They have limited applicability for large and complex issues, and can only deal with them in a suboptimal way. At the program or project level, under given circumstances and assumptions, uncertainties are considered and overall feasibility evaluated.

At the operational level, the policymaker has to specify the ingredients—the choice of the discount rate—for uniform application. In such application there is often a bias, but inasmuch as this is uniform, the net result is not as adverse as it might appear. If the specification is not made in detail, it is likely that the imputation of benefits would be inconsistent and would vitiate the merits of judgment. The cut-off point—below which projects would eliminate themselves—also has to be specified. While conceptually these aspects have the desired logical rigor, in practice much would depend on the numbers generated.\(^2^2\) To the extent these aspects are objective and reliable, they would serve as a useful guide. The persistence of difficulties may often make the policymaker skeptical of the technique and its several imputations and make him view the system more as a sensitivity test to his intuitive approach than the other way round. At the same time, not undertaking analysis would imply the return of rule-of-thumb procedures. The virtue of cost-benefit analysis lies in the fact that it provides a benchmark to guide policymaking and to force the decision maker to concentrate on the objectives of the programs and the relative social values placed upon alternative

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\(^2^1\) It is for this reason that manuals on these techniques emphasize projects and programs rather than goals which, to an extent, are given. See I. M. D. Little and J. A. Mirrelies (1974), Chap. 1. In developing countries, the degrees of development being what they are, choices at the level of functions do not appear to pose major problems in view of the availability of recognized “felt needs,” hence, the obvious emphasis on agriculture, education, and the development of infrastructure.

\(^2^2\) It is also contended that these techniques have not adequately reckoned with the political aspects. For some of these criticisms, see Ida R. Hoos (1969). Her main criticism was directed more to the supersalesmanship of consulting firms (that sprang up in the wake of PPBS) and the overreliance on mathematical tools. Her concern is that analysis could become a power tool in itself. Be that as it may, it cannot be an adequate basis for ignoring the intrinsic merits of the system. Another view is that the provision of guidelines on discount rates, for example, could in due course become a doctrine in large organizations, see James R. Schlesinger (1969).

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outcomes. It is also to be ensured, however, that the application of the technique does not lead to excessive fragmented decision making, which would be true when each project is viewed as a world in itself. Ignoring its linkages to the resource use would harm budgetary decision making.

Another area that is alleged to have been ignored in designing the PPBS is the neglect of the political implications and related aspects of feasibility. While political issues are important (the legislative considerations are different and much of their impact would depend on the legislative system), it would be somewhat farfetched to suggest that a budget system could totally eschew these elements. Indeed, no decision maker lives or works in a hermetically sealed atmosphere; one is only too well aware of the intricacies of politics however remote from the powerhouses that generate them. Wildavsky argued that the people engaged in implementing the system in the U.S. Government were not fully aware of the total political implications and that, in any event, the results of the technique tended to vary from one agency to another. While, undoubtedly, political scientists have a point in reminding the practitioners that the political premises of decision making should not be lost sight of, it appears that they indulged in needless exaggeration.

IMPLEMENTATION EXPERIENCE

The implementation of the PPBS in the U.S. Government, notwithstanding the political commitment, did not deliver the revolution it promised. However, the introduction of the PPBS was followed by a mood of skepticism and disenchantment. The reasons for disillusionment were both situational and administrative. In the traditional context of the legislative and executive relationship in the United States, the former viewed the actions of the latter with distrust and the PPBS did not reduce it. In part, the feeling of distrust was engendered by the way the system was introduced in the Federal Government; this was done in a single move that strained the

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23 It should be noted that the proponents of the PPBS did not assume that cost-benefit analysis would be a panacea for all public expenditure problems or that it would substitute for political decisions, see Novick (1965), p. 20.
24 See, for example, Aaron Wildavsky (1966).
capabilities all around. Mistakes became quite common. It appears in retrospect that analysis was overemphasized at the expense of operations. The budget reviewers were not sure of their role, particularly in relation to the role of the economists, and there was a fear that the views of the specialist would gain ascendancy over those of the generalist. Also, development of the data took time. The system could be applied only to certain segments of new outlays, which constitute a relatively minor proportion of total outlays. Most decisions remained beyond the realm of quantitative analysis. The impact of the system as a whole became marginal. These were compounded further in administering the formal elements of the system. First, difficulties were experienced in sending the issue letters early enough to precede the annual budgetary process and their use was limited by the inadequate analytical capabilities in the agencies. Second, analytical studies proved difficult in view of the lack of proper recognition of the differences between civil and defense areas and among civil agencies. Third, the new program structures became an additional layer rather than a substitute for the previous ones. Finally, with the change of the party in power, the PPBS, which was identified with the previous government, became a liability. The formal identity of the system was, therefore, given up, although some of its elements continue to operate, for example, program classification and the selective application of cost-benefit analysis.\textsuperscript{25} A major victim was the reform movement itself, and with it the efforts of economists to introduce more organized planning received a setback. It is a moot point whether more assiduous application would have had a greater impact. In the event, however, the important contribution of the PPBS was in ideas, which continue to dominate.

In the years that followed, emphasis was shifted in the U.S. Government to the system of Management by Objectives (MBO). This system was also drawn from private sector organizations and was essentially one in which the objectives for each level were specified, conflicts identified, and opportunities provided to management to monitor progress and to evaluate the results. Its emphasis was managerial, while that of the PPBS was economic and financial.\textsuperscript{26} The common element was the specification of objectives, which in this case

\textsuperscript{25}See Allen Schick (1973), pp. 146–56.
\textsuperscript{26}See Bruce H. DeWolfslon, Jr. (1975), pp. 387–94.

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was recognized as a “hierarchy of objectives” that corresponded to the various branches of management. Its focus was narrow and allocative efficiency, which was the aim of PPBS, was incidental to MBO. Because of this narrow focus, it cannot be considered as a substitute for any budget system, although it was, and is, a useful additional tool for the budgeting system.

**Zero-Base Budgeting (ZBB)**

The combination of the PPBS and MBO, and the experience gained over the years, paved the way for the introduction of ZBB in the U.S. Federal Government in 1977. In considering ZBB, however, a distinction needs to be drawn between ZBB that was first introduced in the Department of Agriculture in 1962, and ZBB that was ushered in 1977.

In 1962 the U.S. Department of Agriculture made an effort to introduce comprehensive budgeting in the form of ZBB, which specified that “all programs will be reviewed from the ground up and not merely in terms of changes proposed for the budget year. ... The total work program of each agency must be subjected to an intensive review and evaluation. ... The fact that certain activities have been carried out for a number of years will not, per se, adequately justify their continuation. Nor will the fact that programs are prescribed by statutory law necessarily be a controlling consideration. Program goals based on statutes enacted to meet problems or needs that are today of lesser priority must be re-evaluated in terms of present conditions.” In theory, ZBB called for total cost analysis of all programs every year. The experiment, which was confined to one major agency, proved too elaborate: there was excessive paperwork and little or no change in the size or direction of the budget. Its implementation revealed conceptual difficulties, as well as lack of priorities, and it never became fully operational.

In the early 1970s, experiments were made in the variants of ZBB in the private sector. In extending that experience to government, it was recognized that the weaknesses of the PPBS were that it did not provide an operating tool for managers, or consider the impact of various funding levels, and was not significantly equipped to force the
continual evaluation of ongoing programs.27 These aspects were compensated for in the ZBB when it was applied at the federal level in 1977. By that time, however, the system had gained additional experience in some states as well.

The basic feature of the system is that it requires examination of programs at various levels of resource allocation and performance. Other features are (a) objectives have to be formulated for each agency,28 (b) the activities of each agency are converted into decision packages—that in essence are broadly the same as program categories in previous systems—which are developed to show performance at various resource levels such as "minimum," "intermediate," "current," and "enhancement," levels,29 and (c) the decision packages are then evaluated and arranged at each level of management in ranking order.30 The ranking order enables the agencies to define the minimum effort and to indicate the incremental levels of effort above the minimum for each program. The levels of effort are then arranged in a decreasing order and a cut-off point is established; items below the cut-off point are not funded. Another important feature of the system is, continuing the tradition of MBO, that it specifically assigns a role to the "line" or management officials in budget making and permits them to rank programs as they think fit, programs that are then evaluated successively at each higher level. Final rankings are prepared at the top agency management level, and to that extent it has the capability of generating more responsible administrative planning with full recognition of financial implications. Supplementing this system are the procedures for the formulation of medium-term budgets within the Government and a form of sunset budgeting in the legislature under which cut-off dates for funding are set for programs by legislation.

The implementation of ZBB had apparently been less difficult than previous systems. This may largely be due to the fact that ZBB came into operation after years of experimentation with Performance, Program, and Planning, Programming, Budgeting Systems. Another

27See Peter A. Pyhrr (1973), p. 149 et seq.
28By this time the debate about the difficulties in defining objectives simmered down. Formulation of objectives became a chore in government.
29To some extent, this resembles the A, B, and X budget systems of Canada and other similar practices.
contributory factor has been the budget deficits and the feeling that expenditures needed to be controlled. It is noted that ZBB did not represent a conceptual departure, nor did it require a new apparatus; it was, for all intents and purposes, a logical extension of the previous system. Table 21 summarizes the comparative features of Performance, the PPB, and ZBB systems. Admittedly, there are a number of common features and the innovation of ZBB consisted of participation by managerial personnel and planning at different levels of resource availability. Inevitably there was a debate on the merits of ZBB. Supporters of the system argue that it helps to focus equal attention on the budget base and on the increments of that base, and that it permits adjustment in view of the changing picture of resources. The critics suggest that the system is at best a form of institutionalized incrementalism, wherein, by a routine insistence on nonincremental budgets, agencies can obtain financial security; that emphasis on managerial aspects may drive out policy or program analysis; that all it attempted was a change in the terminology. Moreover, its contribution is limited with regard to transfer payments to other levels of government and households, and the system encourages gamesmanship among the participants. These criticisms have considerable validity, although it should be noted that gamesmanship is inevitable in any organization that has many decision-making centers. To stress the obvious, the system is not a panacea. It cannot make tough choices by itself or resolve political differences. The system itself has been in limbo since the change of government in 1981.

IMPLEMENTATION OF REFORMS IN INDUSTRIAL COUNTRIES

As noted in previous chapters, the problems of expenditure control spurred a search for new tools and systems. Many industrial countries have undertaken reforms to improve their budget systems since the mid-1960s. Some of these reforms were undoubtedly due to the demonstration and ripple effect of the United States, as its experiences with the new systems came to be closely examined and, as its effort became part of literature, the awareness of the problems grew and solutions were influenced by the design of Performance and the PPB Systems in the United States. This is illustrated by the experiences of the United Kingdom, Canada, France, and Sweden.
UNITED KINGDOM

The experience of the United Kingdom is far more varied than others and, in more than one way, parallels experiments in the United States. The difference, however, is that in the United Kingdom the search was also for instruments that would be of greater use in demand management. The first attempt at improving the budgeting system was through functional costing, which was introduced in the mid-1960s. Following the system of program budgeting in the U.S. Department of Defense, a form of functional costing consisting of a program classification of the activities of the current and future costs of military programs and providing a common language for the military and the financial planner was introduced. The application of quantitative techniques for program analysis was also initiated. The application of these analyses and costs were, however, restricted to largely internal management purposes.

Later, following the introduction of the PPBS in the U.S. Federal Government, the U.K. Government also reviewed the applicability of the functional costing system to civil agencies and some pilot studies were carried out. The review revealed the need for a system with a different focus and mix to meet the disparate requirements of the wide spectrum of civil agencies. The result was a system known as output budgeting. Output budgeting was, in its initial form, the same as Performance and Program budgeting systems. The basic aim of output budgeting was to relate all costs to functional objectives, to ascertain the use of resources, the ends for which they are used, and the results.

Later, a formal structure was provided for the system. It consisted of the following: (a) A program budget that showed, for each program, proposed expenditure and whatever quantitative measures of output that could be meaningfully constructed and used on a regular basis. This phase included the review of the continued validity of the objectives. (b) Special studies, either to establish the value for money or alternative ways of achieving the given objectives. These features, it will be recognized, were for all intents and purposes, the same as those of the PPBS.

31 See, for example, United Kingdom, Output Budgeting for the Department of Education and Science: Report of a Feasibility Study (1970a).
32 See Alan Williams (1968).
Table 21. Features of PPB and ZBB Systems

<table>
<thead>
<tr>
<th>Systems Elements</th>
<th>Performance Budgeting</th>
<th>Planning, Programming, and Budgeting Systems</th>
<th>Zero-Base Budgeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Organization</td>
<td>Agency</td>
<td>Function</td>
<td>Decision unit</td>
</tr>
<tr>
<td>2. Objectives</td>
<td>Specific objectives of the agency</td>
<td>Functional objectives and their relationship to national goals</td>
<td>Specification of short-term objectives, particularly in regard to increments proposed</td>
</tr>
<tr>
<td>3. Classification aspects</td>
<td>Functions, programs, and elements of expense that form integral parts of the budget structure</td>
<td>Functions and programs independent of the budget structure</td>
<td>Decision packages and consolidated decision packages that are flexible and independent of the budget structure</td>
</tr>
<tr>
<td>4. Analytical aspects</td>
<td>Emphasis on outlays-performance relationship</td>
<td>Application of quantitative techniques and evaluation of alternatives</td>
<td>Emphasis on monetary and performance increment relationships and ranking of decision packages in terms of different assumptions of resource availability. Preference for descriptive and explanatory statements on alternatives and in support of choices made at lower levels</td>
</tr>
<tr>
<td>5. Budget and planning</td>
<td>Separate</td>
<td>Integrated within the annual budget cycle</td>
<td>Integrated</td>
</tr>
<tr>
<td>6. Time-horizon</td>
<td>Annual</td>
<td>Five-year forecast</td>
<td>Four-year projections to be indicated but their role in overall budget formulation less specific</td>
</tr>
<tr>
<td>----------------</td>
<td>--------</td>
<td>--------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>7. Evaluation aspects</td>
<td>Quantitative measurement of performance</td>
<td>Emphasis on evolving information systems</td>
<td>Emphasis on performance and its measurement</td>
</tr>
<tr>
<td>8. Intended extent of annual application</td>
<td>Throughout government</td>
<td>Throughout government</td>
<td>Throughout government</td>
</tr>
<tr>
<td>9. Intended benefits</td>
<td>Results for outlays and greater cost consciousness</td>
<td>Allocative efficiency</td>
<td>Greater involvement of the line managers in the budgetary process, measurement of performance, and a credible rationale for reallocating resources</td>
</tr>
</tbody>
</table>
Output budgeting was never formally introduced in the government. Instead, reflecting the major changes that took place in the organization of the Government, it came in the form of a new package—a three-tier decision-making system, comprising some elements that were already in operation. The ingredients of this package were (a) the Public Expenditure Survey Committee System (PESC), (b) the Program Analysis and Review (PAR), and (c) the Central Policy Review Staff (CPRS). The features of PESC have been discussed in Chapter 6. The PESC, it will be recalled, did not explicitly state the objectives of expenditures to be tested against the general government strategy, nor did it embody detailed analysis of policy options. These were to be compensated for through PAR, which in a way was a combination of output budgeting and management by objectives. Its purposes were to contribute to the overall strategy by focusing on issues for collective consideration and to review the major ongoing programs (a feature distinguishing it from the PPBS). PAR studies could have a longer time horizon than the three-year period of PESC. The choice of the subjects taken up for analysis was more selective and was made with reference to significant issues or areas that had substantial outlays. PAR required a constant dialogue between the Finance Ministry and the spending agencies and among the spending departments by identifying the main determinants of expenditure and their interaction among programs. The third element was the CPRS, which was broad based and was concerned with the strategic objectives and priorities of the government as a whole. Conceptually, its approach and analysis form a vital analytical input into the decision making of government and provides an umbrella over the work of the

15 The objectives of PAR were rather ambitious for essentially they sought to review the major policies of government, which probably could not be done through a mechanistic process but required tackling at a political level. In addition, the arguments made against the feasibility of rational analysis of PPBS are also advanced in regard to PAR and it was held that being too bureaucratic and being imposed from the top, it failed to take into account the different requirements of the enormous range of government business. A simplified version of PAR, known as "Scrutinies," is now in use in the United Kingdom but being essentially oriented to securing efficiency in implementation, it should be considered as a technique that has greater relevance in the budget implementation stage than in budget formulation. See also Chap. 9.
PESC and PAR. The activities of CPRS preceded the budgetary cycle and its concerns were more than financial. As an agency that functioned as a part of the Cabinet office, its actual operations were dependent on its relationship with the Cabinet. During recent years some of its studies became more controversial, but essentially the budgetary system continues to follow the major elements of the PESC with only incidental influence from CPRS, and PAR appears to have fallen into some disuse as financial crises in the government required more drastic policy measures. Moreover, reflecting the impact of inflation, greater reliance has come to be placed on the system of cash limits.

**CANADA**

The review of the governmental machinery in the early 1960s by the GLASSCO Commission contributed to the initiation of performance and program budgeting variations in Canada. Following the U.S. Government experiment with the PPBS, a few pilot studies were made to consider its feasibility, and it was decided that the application of the new system should be extended to all government departments. It was later extended to some state governments. The Canadian approach is slightly different from the U.S. PPBS in that greater emphasis was laid on expenditure planning and assessment of efficiency. Expenditure planning itself was in two stages. In the first place, expenditure planning consisted of the preparation of three budgets with varying amounts of expenditures at the current, increased, or reduced levels. It is in the preparation of the second type of budget that cost-benefit analysis was sought to be applied. The second level relating to assessment of efficiency, determination of expenditure inputs was, however, delegated to the administrative departments. Another feature of the Canadian approach is its emphasis on efficiency in resource utilization. Although the measurements or indicators of efficiency have not always been regarded as integral parts of the budget cycle, it is noteworthy that selective measures, such as cost per unit, output per dollar cost, real output per man year, were evolved and responsibility centers for monitoring costs were set up in spending agencies. Experience of the system has been rather limited and in the late 1970s attention was diverted to the political problems of budgeting which were contained through the envelope system.
FRANCE

A variant of the PPBS was also introduced in the late 1960s in France. The experience was divided into two phases. As applied in the defense organization, it was known as “Planning, Programming, and Preparation of the Budget,” and offered a coordinated framework for centralized decision making and control. Its application in the civil departments was known as “Optimization of Public Expenditure,” which laid more emphasis on the application of investment appraisal techniques. Later, both of these were combined into what has come to be known as Rationalization of the Budget Choice (Rationalisation des choix budgétaires—RCB). This system, like the PPBS, has three components—a program structure, analytical studies, and an information system. The implementation of RCB reveals three distinctive features. First, analytical studies were undertaken more in the nature of planning inputs for finalizing government investments and were not linked to the budgetary process. This proved efficacious in France in view of its well-developed formal planning systems. Second, it was recognized that central enforcement of the system might lead to the development of counterbalancing forces. To this end, departments were encouraged to develop their own approaches to meet their unique requirements. Third, it was also recognized that the introduction of the system, if it was not to overextend itself, would have to be selective and gradual. The system, as it obtains now, is used by some spending agencies and is not a centralized system imposed from above.

SWEDEN

Variants of the PPBS have been used in certain areas of civil administration since 1968 and in the defense administration since 1972. Although it was among one of the first European governments to show interest in the PPBS experiments in the United States and published Swedish translations of the PPBS literature, the acronym or its equivalent appears not to have gained acceptance in Sweden. Reviewing the situation, the Budget Commission in its report Proposal for a Reform of the Swedish Budget System (1974) made a distinction between program budgeting or planning and functional budgeting—the former directed more to the planning of inputs and the latter concerned with control—and recommended the latter. Its
concept of functional budgeting was, despite the technical distinction, broad based and included the specification of objectives, identification and planning of commitments through medium-term surveys, formulation of program structures, evaluation of reasonable alternatives, and measurement of costs. In making these elements operational, the proposal recognized that there were a number of multigoal activities and several activities contributing to the same goal, and where multiple agencies pursue the same goal, coordination was to be achieved by administrative procedures rather than by program structures or administrative reorganization. The present budget system has several elements that combine planning, medium-term forecasting, and efficiency measurements.

OTHER COUNTRIES

The impact of the PPB and related systems is also to be seen in several other countries, although the application as well as its modes differ from one country to another. Japan, for example, gave active consideration to the introduction of PPBS variants. There was a keenly felt awareness that its budget structure was diffuse, its decision making fragmented and more concerned with consensual validation than with allocative efficiency, and that the budgetary process was nonprogrammatic and iterative. It was to avoid this that the Economic Planning Agency initiated research into the feasibility of systems similar to the PPBS. The emphasis of the Planning Agency was notably on providing a framework with a built-in incentive for the agencies to plan their activities rather than to be concerned with the annual increments in the budget. It was also expected that such an effort at planning would result in the minimization of political influence. Despite a growing recognition of the useful features of the new system by both agencies and the Ministry of Finance, not much headway has been made in its implementation, although during the late 1970s medium-term financial surveys were initiated.

Several other countries saw the need more in terms of selective strengthening of their systems than in total revamping by the introduction of a PPBS. Austria, Denmark, the Federal Republic of Germany, New Zealand, and the Netherlands are among those that introduced a wide variety of reforms involving selective reclassification of budgets into programs, medium-term forecasts, the introduction of
appraisal techniques, and the measurement of productivity and performance in some departments. More recently, Greece has initiated a three-year implementation of a form of zero-base budgeting and productivity assessment program. Here again, the effort is oriented more toward selective adoption of some features of ZBB than to a transplantation of the U.S. system.

**DEVELOPING COUNTRIES**

As developing countries attained independence in the late 1940s and early 1950s it became clear that inherited systems of financial management were not best suited to the changed role of governments in the context of development. The budget structures and financial management systems were found to be archaic and functionally weak. There was little or no systematic viewing of proposals or planning of expenditures. Central controls were illusory and accounting and reporting received scant attention despite their importance. Identification of these aspects did not take too long and the long journey toward modernization was charted to rectify chronic disorders in obvious areas. The reforms included improved budget agencies, reorganized budget structures, and selective strengthening of financial management capabilities in spending agencies. The emergence of planning as a separate art temporarily took care of the problems of expenditure planning. It was expected that the allocative efficiency of expenditures would be ensured by the development plans. It is the continuing search for performing traditional and new tasks that caused developing countries to experiment with performance and program budgeting systems after the mid-1960s.

To some extent, these efforts received added impetus from the publication of a manual and advocacy of Program and Performance Budgeting by the United Nations. The system proposed by the United Nations was essentially the same as performance budgeting and consisted of interrelated elements of appraisal techniques, and the measurement of productivity and performance in some departments. More recently, Greece has initiated a three-year implementation of a form of zero-base budgeting and productivity assessment program. Here again, the effort is oriented more toward selective adoption of some features of ZBB than to a transplantation of the U.S. system.

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program structures, a system of accounts, and financial management in line with the classification and measurement of efficiency. It is different from the PPBS approach in that the UN Manual did not advocate the application of cost-benefit analysis or related techniques. It envisaged the new budget system "as an effective instrument in the implementation of development plans," although the Manual itself did not discuss the nature of problems encountered in the implementation of development plans or the adequacy of the proposed system for meeting these specific tasks. The implications of the new systems for the developing countries were manifold. If the emphasis on quantitative criteria were converted into practical budget making, it would have helped to reduce the extent of dualism discussed earlier. Similarly, the structural features and the appraisal techniques would have enabled decision makers to look beyond their traditional horizons into the wider implications of programs as a whole. Some of these advantages were recognized by the developing world, which tried to make the abrupt transition from conventional budgets to the family of modern budget systems. Several countries in the Asian, African, Middle East, Caribbean, and Latin American regions have introduced types of Performance and PPB systems, but the features of the systems introduced, as well as the approaches to reform, are by no means uniform and in fact are considerably diverse.

In some countries, the introduction of the system was influenced substantially by external factors. For example, the Philippines, which was one of the earliest to adopt performance budgeting, was clearly influenced by contemporary developments in the United States and the impetus for introduction came, to a large extent, from external technical assistance. Similarly, in Malaysia the initial thrust for reform came from the review of administrative machinery carried out by foreign consultants (as in Tanzania) and in Nepal the reform movement was initiated through technical assistance arrangements. Bolivia, Honduras, India, Kenya, Lesotho, Malawi, Sri Lanka, Uganda, and Venezuela were all substantially influenced by developments abroad, but the initial efforts (and in some countries total efforts, e.g., India) were organized domestically. It was an awareness of external develop-

opments that prompted them to review the inadequacies of the traditional systems and it was the same factor that induced a breakaway from them. The systems, as implemented, represent a wide variety and are such that they cannot be considered as Performance or PPB systems. In countries such as India, which sought to introduce Performance Budgeting, the specification of the efficiency yardsticks and cost implications are still at a nascent stage. In countries that attempted PPB systems, planning machinery has developed independently from budgeting and, to that extent, has permitted convenient adaptations rather than a strict adherence to the PPBS paradigm. The introduction of the system in India, Indonesia, Malaysia, Nepal, and Sri Lanka did not bring about a change in the functioning of planning and budgeting, which continued to be performed on a dual basis. In some countries where revised budget classifications were introduced, better coordination appeared to be achieved in presentation. The analytical aspects of the system remain largely unimplemented and a shift to a more objective or quantitative approach is found to be difficult and is often resisted. The task has not been rendered any easier by the little attraction the terminology of these techniques had for line employees. The coverage of the new systems is also limited. In Malaysia and Indonesia it is limited to the development budget, while in India performance budgets are prepared as supplementary documents. It also appears that the new systems have not yet become instruments of management either in finance ministries or in plan agencies. Thus, implementation has been spotty and several features remain to be introduced. The traditional system still obtains and it will be a long while before it is replaced. Table 22 illustrates features of the new systems in some developing countries in Asia and indicates the extent of progress made.

IMPLEMENTATION LESSONS

The implementation of the systems reveals that those in operation cannot be described as a single system but as a family of systems where selected features that are relevant and feasible are applied. Table 23 summarizes the previous discussion and shows the general features of the systems in selected industrial and developing countries. This indicates that while the systems had various names, they also had
several common elements, such as classification, specification of objectives, and evaluation of efficiency. While discussed in terms of a packaged system, they seem to generate greater controversy, in reality and devoid of a label, the ingredients described in the table gain acceptance when viewed as a continuation of the budgetary process. Indeed, some countries such as the Federal Republic of Germany have all the features but no descriptive label. Gibbon wrote that mankind is governed by names. Labels appear to have become more controversial than beneficial when applied to budget technology.

The above should not be taken to imply that the systems are fully operational in the areas shown or that their benefits have been fully reaped. The implementation in several countries has been difficult and in some case halfhearted, and it seems that in developing countries, it cannot be disassociated from the plethora of problems associated with extensive needs and low capacities. Lack of training facilities, shortage of skilled workers, inadequate phasing, disillusionment with excessive paperwork, nonutilization of the information generated, utilization of the information for strengthening centralized controls, lack of adequate involvement of spending agencies, lack of proper hybridization of some techniques, and too ambitious an application are a few of the easily discerned features. There were also substantial lags in adjusting to the new requirements the supplementary systems such as reporting and accounting. These aspects contributed to poor results, which in turn contributed to a series of questions and doubts about budgetary reforms, their impact, and relevance for the future.

EVALUATION OF BUDGET INNOVATIONS

Have these reforms succeeded? Wildavsky asserts that "[m]ost reforms fail . . . the governmental landscape is littered with their debris."39 Informed skepticism is, however, no substitute for substantive analysis. In evaluating reforms, numerous problems arise. One of the somewhat intractable subjects that has been debated for years in economics is the measurement of technical change and its impact on production. One belief is that the results of technical change become embodied in capital equipment and cannot be distinguished. Another

### Table 22. Implementation of PPPB Systems in Selected Asian Countries

<table>
<thead>
<tr>
<th>General Features of the Systems</th>
<th>India</th>
<th>Malaysia</th>
<th>Nepal</th>
<th>Philippines</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td>Special Features Applicable in Selected Countries</td>
<td></td>
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<tr>
<td>I. Determination of objectives</td>
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<tr>
<td>Determination of national objectives</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Determination of objectives of sectors</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Determination of objectives of programs</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Determination of advance program of work</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>II. Structural or taxonomic aspects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classification of government transactions into functions, programs, and activities</td>
<td></td>
<td>3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>III. Analytical aspects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Application of cost-benefit analysis, systems analysis, special studies, etc.</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>IV. Predictive features</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Projection of government outlays over an adequate time-horizon</td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budgeting within specified ranges</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>
### V. Appraisal and evaluation aspects

<table>
<thead>
<tr>
<th>Establishment of information systems</th>
<th>Quantitative measurement of outputs in relation to specific objectives of programs</th>
<th>Formulation of standards for measurement of performance</th>
</tr>
</thead>
</table>

### VI. Intended extent of annual application

<table>
<thead>
<tr>
<th>Throughout the government</th>
<th>Selected key areas</th>
</tr>
</thead>
</table>

* Denotes features applicable.

1. This is done as an integral part of the medium-term development plans.
2. Restricted to the programs included in the development plans.
3. Restricted to the development budget.
4. Progress in this regard is highly uneven and, in any event, there is no uniform application of this criteria in the annual budgetary process.
5. Projections are undertaken for the aggregates and not for individual programs.
6. Generally restricted to the development budget.
7. The application is uneven and the quality varies from one to another.

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Table 23. Application of Modern Budgetary Techniques: Variations on a Theme

<table>
<thead>
<tr>
<th>General Features of Systems</th>
<th>United States</th>
<th>United Kingdom</th>
<th>France</th>
<th>Canada</th>
<th>Sweden</th>
<th>UN System</th>
<th>Tanzania</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Determination of objectives</td>
<td>Performance budgeting</td>
<td>Planning, program, budgeting system</td>
<td>Functional costing</td>
<td>Output budgeting</td>
<td>Program analysis and review</td>
<td>Rationalisation des choix budgétaires</td>
<td>Planning, program, budgeting system</td>
<td>Functional budgeting</td>
</tr>
<tr>
<td>Determination of national objectives</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Determination of objectives of sectors</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Determination of objectives of programs</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<td>X</td>
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<td>X</td>
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<tr>
<td>Determination of advance program of work</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

II. Structural or taxonomic aspects

| Classification of government transactions into functions, programs, and activities | X | X | X | X | X | X | X | X | X | X |

III. Analytical aspects

| Applications of cost-benefit analysis, systems analysis, special studies, etc | X | X | X | X | X | X | X | X | X | X |
### IV. Predictive features

- Projection of government outlays over an adequate time horizon

### V. Appraisal and evaluation aspects
- Establishment of information systems
- Quantitative measurements of outputs in relation to specific objectives of programs
- Formulation of standards for measurement of performance

### VI. Intended extent of annual application
- Throughout the government
- Selected key areas

---

1. *X* indicates the features applicable to the system.
2. For this purpose, the features of the work of the Public Expenditure Survey Committee and the work of the Central Policy Review Staff are considered as integral parts of Program Analysis and Review. Each one has a separate role but are so structured that they complement each other.
3. In Canada more emphasis is laid on formulating three budgets.
avers that the contribution of technical change may remain disembodied and that it can be measured by selected proxies. The measurement of contribution of budgetary reform is, if anything, even more difficult. For one thing, the period of implementation and experience with reforms has not been long. For another, government activities cover as wide a range as the reforms and trying to measure them by a single yardstick does not permit a fair assessment of the reforms. The contribution of reforms is contingent on the situational factors (need for reform and timeliness in the submission of recommendations), structural factors (relationship between government and the legislature), behavioral factors (motives and attitudes at operational ranks in government), human skills (availability and utilization of skills), and economic factors (phase of the cycles and levels of taxation and expenditure), and the separation and measurement of the contributions of each of these factors is formidable.

Some criteria to assess reforms have been considered during recent years. One test frequently offered is whether the reforms succeeded in reducing expenditure growth. The experience of the previous three decades suggests that the objective of the reforms was different. Primarily it was to improve efficiency rather than to reduce expenditures. The empirical verification of the test was sought by measuring the costs of government services and the general conclusion was that costs tended to rise. It has to be recognized, however, that the tests were concerned with costs rather than with quality. Also, the pursuit of stabilization in certain situations may imply the need for more expenditures (in aggregate) than less. Thus, the validity of this test is somewhat dubious. A second test proposed was that changes in budget concepts should be evaluated in terms of the outcome of the budget process, or the accuracy of budget estimates rather than comprehensiveness or procedural control. The problem with this test is that it provides a single criterion for judging a broad range of issues. Several factors, including experience in fiscal marksmanship, affect budgetary outcome and a test of fiscal slippage can, at best, demonstrate the weaknesses of a few selected areas and cannot capture the full implications of the overhauling aimed at by reforms. Other tests include contributions to national development and allocative efficiency. Both these criteria need ex ante specifications with reference to

which ex post performance could be measured. Even then, it is difficult to single out budget reform as being responsible for a better or proper economic performance. Similarly, allocative efficiency may be improved or hampered by policy or technical factors and the separation of these factors is not easy. On one hand, it could be argued that properly organized budget processes should imply formulation of proper policies. On the other hand, it is also accepted that decisions affecting the design of allocation of resources are more political in nature and cannot be measured in terms of budgetary reforms. This is not to suggest that reform should be considered on trust and considered a success. Experience of reforms mentioned above reveals that reforms tend to be successive, not because they are less satisfactory in meeting the tasks (although this does arise with inadequate implementation) but more often because of rapid changes in the challenges facing the government. By the time some progress is made in meeting some of the tasks, new problems arise and either new systems have to be introduced or previous ones strengthened. The cumulative capabilities of the systems offered more facilities and greater strengths. When promptly implemented, the reforms are clearly helpful in clarifying the activities of the government, in being a better tool of economic policy and management, in bridging the gap between plan and budget, and in general as an instrument of government administration. It is difficult to imagine that the complex problems of public expenditure management illustrated thus far could have been solved by the traditional budgeting system. While budget innovations do not offer a foolproof system or a panacea, they are capable of offering a more viable long-run alternative to the systems that hitherto prevailed in most of the world. The critics appear to have been more concerned with the negative rather than the positive aspects.41 This approach itself reflects a search for a Holy Grail. In public policy matters, however, experience conclusively indicates that there is no single system that can provide all the answers, and if such a system were to exist, by itself it could not deliver the goods unless supplemented by adequate personnel. Moreover, to yield the benefits expected, it must be given a fair period of trial.

41 Francis Bacon's remark that "they are ill discoverers that think there is no land, when they see nothing but sea" is apposite in this connection.
Reforms should perhaps be considered not merely in terms of their shortcomings but in terms of the new issues arising and the large gaps still remaining to be closed. Viewed from this angle, there are areas that need continuing attention—improvement in forecasting, flexible approaches for short-term adjustment in expenditures, inflation budgeting, development of cost and productivity measurement, building up financial management competence in spending agencies, and extending the improved systems to state and local governments. The solutions to these problems are best seen, not in terms of a particular system but as various parts that are appropriate to the specifics so coordinated as to improve the overall financial management system. Therefore, they have to be substantially more than the improved systems discussed earlier. All in all, little respite is in sight for those engaged in improving budget systems. The need for providing a continuing response to changing problems is inherent in government management and cannot be overemphasized.
Budget execution has been a neglected area of government financial management. For too long it has been viewed primarily as a process concerned with the preaudit of government bills and procedures of their payment. Legal aspects of payment, the nature of service provided, its relationship to the government budget, the technical authority of the agency that authorized the payment, and the review of the accuracy of the proposed payment were, by and large, the components that received attention. Some viewed budget execution as an administrative process, while others analyzed it as an extension of the budget formulation stage with the same strategies and game plans adopted by central and spending agencies. In reality, however, budget execution and related aspects of cash management (which have become important in their own right during recent years) are more than the sum total of the above elements. Budget execution represents the phase during which the multiple aspects of resource use acquire an importance that is uniquely their own. It is also a phase where the relationship between central and spending agencies is even more important than it is during the budget formulation stage. Formulation is a phase that is relatively short in its duration. Budget implementation, however, is a phase that is felt throughout the fiscal year. As an activity, it involves the mobilization of human, material, and financial resources through a number of techniques and procedures. If the result of the budget formulation stage is a blueprint for the allocation of
resources embodied in the budget document, budget execution has more onerous tasks to perform as it has to provide goods and services to the community. Such provision involves all branches of government, unlike the more technical and selective participation of officials in budget formulation. Execution is the cutting edge of the budget and it is the phase in which government interacts more actively with the community it represents. Implementation is, however, a positive process and is dependent for its success on financial procedures and general administrative capabilities. For these reasons, implementation cannot be considered as a budgetary problem alone but has to be examined for its widest implications. Its importance has grown during recent years, primarily because many development plans have run aground on the rock of implementation alone.

ENDS AND MEANS FRAMEWORK

The process of formulating a development plan or the annual budget involves an implicit assessment of the implementation capabilities of the various agencies. The availability of performance budgets, with their emphasis on identification and measurement of the productivity and workload factors, will help such an assessment. In practice, however, owing to the nonimplementation of performance budgeting, and also because emphasis tends to be diverted to the financial aspects, the capabilities of the agencies per se appear not to have been given due recognition. The built-in optimism among government officials that somehow the machinery will be equal to the tasks expected of it may also have contributed to the situation. This feeling is encouraged to some extent by the generally held view among spending agencies that the key problem is one of finances and not that of absorptive capacity of the economy or the implementation capacity of the agency. Experience of both industrial and developing countries suggests that the recognition and evaluation of the implementation capacities have fallen somewhere between the emphasis on the financial aspects of plans and budgets, on the one hand, and the complacency of the agencies, on the other. Over the years the nonfulfillment or partial fulfillment of plans and budgets have led to greater attention to this aspect. The response to this recognition has been twofold: (a) several development plans now contain brief chapters on implementation aspects, and (b) many governments have initiated a series of administrative reforms geared to
simplifying government procedures and to an overall improvement in government operations. The impact of these approaches on budget implementation is, however, a moot point. In both cases, the specific tasks of budget implementation do not appear to have been given their due and have been treated in a general fashion.

Implementation of the plan and the budget requires an advance program of action evolved within the parameters of the ends of the budget and the means available. Ideally, this framework should include (a) identification and enumeration of the implementation tasks, (b) assessment of the suitability of the means for achieving the ends, and (c) prospects for the improvement of means if they are less than adequate. This exercise reviews the implementation factors, with specific attention to (a) the nature of government activities and their demands on executive capacity, (b) the adequacy of executive capacity in relation to demands, (c) the capability of the economy to provide real resources and the role of foreign and domestic constraints, and (d) recognition of structural bottlenecks such as monsoon cycles and related weather factors.\(^1\) In assessing these factors, an integrated plan indicating the time sequence of administrative action and flow of expenditure has to be formulated. Such a plan would constitute the starting point for the formulation of the budget and its implementation. Lack of attention to these aspects would contribute to the plethora of problems, such as straining the capacity of the administrative system by overpitching demands, and to the facile explanations that lack of progress was due to shortages of finance, labor, and physical resources.

**Budget Implementation Process**

The primary concern during the implementation of the budget is to ensure the fulfillment of the financial and economic aspects of the outlays. The financial tasks include spending the amounts for the purposes specified, minimizing savings, and avoiding lapses and/or a rush of expenditure toward the end of the financial year. The economic tasks consist of ensuring that the physical targets of programs have

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\(^1\)In some countries, the political factors may also have a dominant role. These may contribute to several distortions. For an illustration of the working of these factors, see Edwin Dean (1972), p. 50, et seq.
been achieved. It is hoped to achieve these two purposes by budgetary controls exercised by the central agencies and spending departments. The budgetary and economic tasks are rendered operational through the administrative process that comprises four major interrelated phases of work: (a) an allocation system under which expenditure is controlled by release of funds, (b) supervision of the acquisition of goods and services to ensure value for the money spent, (c) an accounting system that records government transactions and provides a framework for an analysis of their implications, and (d) a reporting system that permits a periodic appraisal of the actual implementation of the policies. In all these phases, illustrated in Chart 5, the administrative and budgetary tasks interact with each forming the basis for the other’s work. Neither of them can be performed in isolation from the other and their relationship, like others in the overall budget process, is symbiotic. The concerns in all these stages are three: (a) to ensure legal accountability, (b) to achieve efficient use of resources and, (c) to ensure the flexible use of resources by avoiding the immobilization of funds. The budgetary process, by its very nature, involves the allocation of funds to a few and the denial of many requests, and there is an obligation that those who are allotted funds actually spend them. This does not necessarily mean an exhortation to spend irrespective of the need. However, the implication is that funds should be diverted to areas where there is need, which is further exemplified by the general compulsions of economic growth. Such flexibility, as noted earlier, is a two-way operation involving restraint and stimulus. These tasks and some procedures are common to both industrial and developing countries. Individual differences have generally occurred because of legislative requirements or administrative background.

**RELEASE OF FUNDS**

The procedures for the release of funds have a hoary past going back to the era during which an exchequer system was evolved. For example, in the United Kingdom in this early phase there were three officers—a teller who was the cashier who received and issued the money, a clerk of the pells who recorded on a parchment all receipts and issues, and the auditor who examined the records and whose duty was to see that no money was issued except with the sanction of
Chart 5. Budget Implementation Process

Central agencies

Exchequer issues

Financial management process

Budgetary tasks
1. Controlling flow of expenditures
2. Overall plan for cash management
3. Central oversight on payments or administration of payments where centralized
4. Final consolidation of accounts and progress reports

Administrative tasks
1. Overall review of progress independently or jointly with spending agencies
2. Revision of policies where appropriate
3. Diversion of funds to needy areas

Spending agencies

Funds made available to agencies

Financial management process

Budgetary tasks
1. Making commitments
2. Acknowledgment of receipt of goods and services and certification of transactions for payment
3. Monthly and annual rendition of progress reports and accounts
4. Avoidance of shortfalls and excess and rush of expenditures
5. Timely surrender of funds or processing of requests for additional funds

Administrative tasks
1. Action to initiate implementation
2. Plan for regular flow of expenditure
3. Periodic review
4. Analysis of variations
5. Analysis of budgetary lags
6. Matching financial and physical progress

Evaluation and audit
Parliament. With the establishment of the Bank of England, changes were made in these procedures and a formal system of exchequer issues was introduced in the United Kingdom through the Exchequer and the Audit Department Act of 1866. Under this system a Royal Order authorized the Treasury, with the concurrence of the Comptroller and the Auditor General, to issue the amounts voted by Parliament, which are then placed at the disposal of the Treasury. These are then transferred to the account of the Paymaster General, who makes available the requisite amounts to spending departments. The purpose of this somewhat ceremonial and, as Hilton Young called it, pompous affair, is to adhere to Parliament's wishes and to avoid locking up funds with spending agencies. Variations of this procedure are in vogue in most Commonwealth countries. In some Latin American countries, funds are made available in a similar manner by the Comptroller General. In the U.S. system, the appropriation legislation itself specifies the amounts that would become available to the spending agencies but these are regulated, for purposes of overall cash management, by the Office of Management and Budget through a quarterly apportionment system.

The prevailing practices in industrial and developing countries may be classified into three types. The first type is one in which amounts are available to the spending departments as soon as the budget is approved or the departments are given full authority at the beginning of the fiscal year. Some Commonwealth countries such as Bangladesh, India, and Sri Lanka belong to this category. A second arrangement is one under which formal warrants are issued by the finance ministries to the spending agencies. Funds may be placed in their entirety or in part and may be made available by different central agencies for varying periods. For example, in Caribbean countries warrants are issued more as a routine for the entire amounts budgeted. Frequently, however, some limitations may be put on the use of the funds in that specific projects may require prior approval by the central agencies for the release of funds. In Tanzania funds for the recurrent budget are released for the fiscal year, while for the development budget releases are made in an ad hoc way for each major project after ensuring that the previous apportionments have been fully utilized. The authority for the issue of

2For a more detailed description of the system, see Willoughby, Willoughby, and Lindsay (1929), pp. 36–38; and A. Premchand (1966b), pp. 330–35.

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warrants is divided between the Ministries of Finance and Planning, respectively, for the recurrent and development budgets. A third arrangement is the one in which fixed amounts are released for a specified period. In Haiti, for example, one-twelfth of the budgeted amounts is released every month. In the United States and the Philippines, and in a few Latin American countries, funds are allotted for each quarter. Under this system, the spending agencies furnish a forecast of their requirements for each quarter on the basis of commitments and expected payments. After review, appropriate apportionments are made and a certain amount is centrally retained for contingent purposes. In the United Kingdom, the issues by the Paymaster General do not strictly adhere to a quarterly pattern but follow a somewhat complex accounting formula under which adjustments are made for the issues already made and utilized, and for those that the agencies are entitled to. After the introduction of the formal expenditure planning system, the issues by the Paymaster General lost their symbolic importance and yielded to the quarterly profiles of expenditure prepared in advance by the spending agencies. These profiles have become the basis for controlling and monitoring expenditures.

The smooth working of the third arrangement requires that agencies prepare forecasts of their requirements. The actual success of the financial aspects of the budget would depend on the care taken in formulating these forecasts. The first and second types of arrangement do not always require such forecasts—a feature that implies the absence of an advance plan of any action. In such a situation, the relationship between central and spending agencies becomes more ad hoc and could frequently become a source of irritation. General and unconditional releases have a deceptive simplicity about them, for they suggest the assurance of funds to spending agencies. In reality, however, these releases are subject to limitations and may frequently involve intervention by central agencies. Release of funds is an instrument that has two edges. Used judiciously, it can facilitate the implementation tasks of the spending agencies. Negative use, in addition to contributing to greater centralization of power, could hamper the activities of the agencies. A common problem experienced in many developing and in some industrial countries is the lack of the phased forecasts of their requirements, which inevitably leads to the types of problems described.
ECONOMIC AND ADMINISTRATIVE TASKS

In analyzing the budget execution process, a distinction has been made between the economic and administrative tasks, on the one hand, and the purely financial management tasks, on the other. The basic concerns of the former are efficiency and economy and involve answers to the three questions that dominate the budget process—in what areas are resources utilized? what is being accomplished with these resources? and how can some of these purposes be better served? These issues require a continuing review of program outlays and the factors contributing to cost increases. In more practical terms, the abstract goals of control are realized through a series of administrative actions, which, while revealing the process at work, also indicate the tasks and issues in greater detail.

Action to initiate implementation

Execution of the budget in the government is best seen, contrary to popular belief, as a cooperative endeavor involving the participation of several levels of government and several agencies at each level. Specifically, there are three organizational factors: (a) Consultation and approval of the state and local governments would be needed for the location of the projects and the provision of municipal services such as water and sewage. These matters involve deliberation by the respective authorities and therefore require time. (b) The division of responsibilities among departments may mean that more than one agency is involved in completing a task. For example, the provision of textbooks (which may be the responsibility of the Education Department) would be possible only with the cooperation of the printing presses, which may be under the control of another government department. In each phase, an agency not only has to plan its own activities but also has to coordinate with another agency; the other agency is an exogenous factor, and the plans of the concerned agency will have to accommodate any uncertainties. (c) For reasons of economy, governments generally have central or common arrangements for the procurement of goods and services or for the delivery of services (e.g., transport pools). Such arrangements impose a degree of rigidity or, at any rate, reduce the overall flexibility of the manager of the programs. Complaints are often made about such arrangements but their drawbacks are less than
the overall benefits that result from such common arrangements. Prudent managers, therefore, accept these constraints as a part of the implementation environment and recognize that, if implementation is to proceed smoothly, the original plan of action should itself accommodate them. Accordingly, a major task, soon after the approval of the budget is to ensure that these technical and formal concerns can be adequately dealt with.

Periodic Review

Government is by far the biggest organization and it has tended to increase in recent years. This larger size necessitated adopting a decentralized modus operandi. In turn, this requires operations at each level being overseen by higher echelons. The operations of each agency affect the finances of the government as a whole, they also affect the central agencies responsible for the formulation and implementation of fiscal policies. It has never been easy to reconcile the diverse requirements of those having central responsibilities with the degree of autonomy considered essential for performing the implementation tasks. This aspect is even more keenly felt in determining the relative role of the spending and central agencies in the budget implementation phase. The agencies have to undertake a review of their own if the budgetary and economic tasks are to be fulfilled. The responsibilities involved, however, are distinct and supplement each other rather than overlap. For the spending agencies, the purpose of their review is not merely to examine the financial trends but to assess the effectiveness of their own administrative policies. The main purpose of the central agencies is to evaluate financial trends and not to function as a substitute for the legitimate concerns of the administrative agency. Their quest is for the identification of the links between spending agencies and the assessment of their combined impact on the economy.

The spending agencies are mostly equipped with budget and planning units to undertake a periodic review, the content of which should ideally include the analysis of variations, budgetary lags, expenditure patterns, and the relationship between physical and financial progress. Each of these aspects are examined below. At this stage, the focus is on the extent to which the technique of review has been used. Periodic review can be ad hoc but to ensure a lasting
contribution should be institutionalized, thus becoming a part of normal administrative life. Although it has the potential of becoming a ritual—a fate that most administrative procedures share—the fact remains that once institutionalized it generates opportunities, expectations, and structured information. A casual examination of the experience of a cross section of countries reveals that periodic review is carried out mostly at the lower echelons, or is routinely performed in systems where funds are released at specified intervals. In some countries, notably India, the spending agencies are required to organize quarterly expenditure control meetings. By and large, this is left more to the initiative, daring, and skill of the individual agency concerned. In crises, however, greater attention is shown at all levels and hitherto dormant channels of communication suddenly come alive with frenetic activity.

The review by the central agencies is, however, more regular and largely reflects the long legacy of centralized financial administration. In the United Kingdom, expenditure divisions of the Treasury are regularly in touch with the finance officers; similarly in the French system the Inspectors General of Finance assume the major responsibility for overseeing budget implementation. In several developing countries these responsibilities are shared by the finance and planning agencies. The requirements of the planning agencies appear to be different and reflect a more active follow-up and intervention in the activities of the spending departments to ensure compliance with the plan. The finance ministries in some countries do not have any means of keeping in touch with spending agencies except for release of funds or during critical periods when the efforts of the government are being guided into specific channels. When normal channels are lacking, the opportunities for the finance ministry to analyze and anticipate the requirements of the spending agencies would also be few and it is likely that major events might develop in an unexpected fashion. These factors underline the importance of having an institutionalized system of periodic review, both within spending agencies and in the central agencies.

Analysis of cost increases

The evaluation reports of the plans and the annual reports of the Audit Department in every country illustrate the general nature of cost
increases in government programs and projects. These increases have become a rule rather than an exception and they could often be more than 100 percent in selected areas; however, as a whole, project costs might be more than 10–15 percent of the budgeted costs. This phenomenon can be partly explained by the budgetary approaches of the spending agencies in that the agencies tend to underestimate the costs in order to obtain quick approval for their pet projects. Such window dressing, however, can only be successful in the short run and cannot have a lasting future. Indeed, these approaches may lead to greater attention being devoted to departments that have been known for doctoring their estimates. Practical experience suggests that factors contributing to cost increases are more genuine and cannot be explained purely in terms of the gamesmanship of departments. Several factors, including changes in prices, structural modifications in the size and scope of the project, changes in the construction schedule, occurrence of unforeseen events, inadequate information in the initial stages on characteristics of the project that may have important cost implications (e.g., foundations of river dams), inadequate information on costs of land acquisition, and physical shortages are known to contribute to sharp cost increases.\textsuperscript{3} To some extent, qualitative factors, such as poor management or poor cost estimation, also contribute to increases. Variations in cost increases among sectors are dependent on the knowledge of costs and the unique features of a sector.

Increases in cost have a major effect in that they have a potential to upset the budgetary balance of the fiscal year, as increased costs could be absorbed only through increased borrowing, revenue mobilization, or expenditure reductions. Approaches for easing the fiscal impact of the inevitable cost increases could be envisaged in two ways. Within the narrow purview of budget implementation, it is important that increases are anticipated in time in order, through periodic review, to facilitate the formulation of policies by which the change could be counteracted or alternatively adjusted.\textsuperscript{4} A longer-term approach consists of improving the knowledge of costs. However, as this can only be of partial help and to minimize the budgetary imbalance, some

\textsuperscript{3}See Maynard F. Hufschmidt and Jacques Green (1976), p. 270, et seq.

\textsuperscript{4}In some countries (India and Saudi Arabia) cost increases in selected areas and within specified percentages are adjusted as a matter of routine. This implies a tacit acceptance of the inadequacy of cost estimates, as well as the inevitability of price increases.
countries have established contingency reserves for meeting cost increases. Such reserves have some definite advantages but it has to be ensured that the existence of a reserve does not necessarily lead to laxness in cost control.

**Budget slippages**

The major focus of financial control at the budget implementation stage is on the identification of fiscal slippages that take the form of shortfall and excesses in expenditures. These twin aspects have been discussed in earlier chapters. The concern here is with their treatment at the implementation stage. If cost increases reflect, to a minor degree, the tendency of departments to underestimate costs, shortfalls appear to be the result of a tendency to play too safe or to overestimate requirements. It may appear slightly incongruous that overestimation and underestimation should coexist, but the areas to which they are applicable are often different. To a major extent, shortfalls are due partly to forecasting errors and partly to structural bottlenecks or physical shortages. The impact of such shortfalls is both positive and negative. In considering the overall fiscal balance, shortfalls mitigate the effect of excesses and thus reduce the adverse effects. However, as these shortfalls are generally fortuitous in their occurrence, they cannot be relied on to provide the necessary neutralizing effect. Indeed, these benefits are more in the nature of hindsight rationalization. In the medium term, however, their impact is more negative as the resulting allocation of resources would be different, depending on the magnitude and area of shortfall, from those planned. Specifically, when these shortfalls occur in growth or employment-oriented expenditures, the objectives in these areas would be less than fulfilled. Further, where actual expenditures are less than estimated, they might have the

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3It is even suggested that in some industrial countries government operations may have grown so much that the central agencies may not have the central capability to detect the upward estimation bias of the spending departments. For an illustration of this aspect with reference to the United States, see Robert W. Hartman (1978), pp.301–305. The British expenditure plans specifically provided for a shortfall as there was a tendency to undershoot their "planning figures" by a small margin. See United Kingdom, "The Management of Public Expenditure" (1979b).

6In developing countries shortfalls in foreign aid contribute to shortfalls in expenditures as the implementation of foreign aid projects is held up.

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effect of accentuating the already existing inadequate utilization of available capacities. These economic aspects need to be given greater consideration than the narrow concerns of financial management.

The avoidance or minimization of shortfalls involves more stringent review at the budget stage and the use of improved forecasting methods. Several countries have traditionally used an historical "spend out rate" for each agency in terms of its previous experience, for determining the possibility of shortfalls. This has not eliminated, and cannot entirely eliminate, shortfalls for as long as the contributory factors emanate from other spheres. The budget implementation phase is concerned with the treatment of shortfalls after their occurrence and not with preventing their incidence. Two courses of action are available to the agencies—to shift the unutilized funds to other needy areas where the prospects of utilization are better or, alternatively, to surrender them to central agencies for diversion to other areas. The former course implies the use of "virement" procedures, under which funds can be transferred from one program to another. The general experience in this regard is that powers achieving such controlled flexibility are few and require fresh legislative approval or acceptance by central agencies. Neither of these approaches is considered appropriate by the spending agencies, which prefer the easier option of benign neglect. In some developing countries this aspect of budget management is further aggravated by the needless fragmentation of budget categories that contribute to small amounts being locked up for a variety of jobs. Denial of freedom to move funds is tantamount to an implicit denial of the necessary managerial freedom. To that extent no budget reform that envisages changes in the approaches and techniques of decision making would have any impact unless accompanied by appropriate adjustments at more practical levels. The latter option of diversion of funds is unlikely to be voluntary in character and would need some subtle detection and prodding on the part of the central agencies. This constructive course of action would be feasible only when the central agencies themselves review the flow of expenditures and have the delegated powers to switch funds. In some developing countries patterned on the British system, the diversion of funds particularly among the development-oriented outlays was possible within the overall ambit of the budget because of the greater involvement of the planning agencies. Elsewhere, particularly in the United States, such diversion is frowned upon by the legislative bodies.
and is viewed as a transgression on the legitimate sphere of accountability.

The impact of excess expenditures on resource allocation is not different from shortfalls but is more aggravating in its implications for stabilization. In the U.S., French, German, and some Far Eastern budgetary systems, expenditures over the total budget are not permitted and there are severe controls to avoid them. In the British Commonwealth systems, although executives are exhorted to avoid excess expenditures and are even threatened with penalties, when these excesses occur, they are routinely regularized through ex post approval by the legislatures. If some systems are stringent to the point of being uneconomic, others appear to be more lenient than necessary. To avoid excess expenditures, greater control is required at commitment, so that a more orderly phasing can be formulated. To the extent that not all excesses can be controlled, it is imperative that they be anticipated and advance action taken to obtain additional funds.

A feature associated with spending is the rush of expenditure at the close of the fiscal year. Variously described as “spree spending” or “squander mania,” this does not constitute a slippage as much as an avoidable nuisance. It is an age-old axiom—although its current validity is not free from doubt—that the pulse of expenditure is not an unimportant index in judging the efficiency of administration. It is also widely held that unless the amounts are spent, there is a potential that future allocations will be scaled down. Both these aspects continue to encourage the agencies to spend the budgeted amounts before the year runs out. This is a common feature of budgetary systems and there is a monotonous regularity in its incidence. Some spending for its own sake inevitably leads to situations where what is needed may not be obtained, and to situations where funds are easily procured but the need is questionable. The adverse impact is obvious. (It is presumably for this reason that no empirical studies have been made regarding the magnitude of this impact.)

This phenomenon can be avoided by two methods: (1) The release of funds may be so controlled as to prevent high expenditures in the last quarter. More is to be gained by having an integrated plan for the

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7The U.S. Congress has legislated that the last quarter expenditures should not be more than 20 percent of the total budget. Agencies could circumvent this by spending more in the earlier quarters. Clearly, the dynamics involved are such that they cannot always be fully legislated.
year as a whole than concentrating on a specific part of the year. As with shortfalls and excesses, there could be a periodic review of commitments and the timing of the releases synchronized with the fulfillment of commitments. (2) The central agencies can assure spending agencies that funds will continue to be provided for as long as they are allocated to approved programs. Rush of expenditure is a manifestation of the anxieties of the spending department. The remedy, therefore, should be to assuage its feelings rather than to exercise controls imperiously. Some countries have sought to make this continuity of budget provision a permanent feature by having nonlapse grants for sections of the budget (e.g., development).

Implementation illusion

Data about the pace and magnitude of expenditure do not fully reveal how tasks are performed. Financial bias, which has been inherent in the traditional budget system, was reduced somewhat with the growing emphasis on ensuring an adequate link between physical and financial progress. The need for such a link becomes even more obvious when there are excess expenditures and an inflationary environment. Excess expenditures may not always reflect cost increases and, sometimes, may well be the consequence of poor management. Similarly, in an inflationary situation, money expenditures may be on schedule and may frequently reflect the implementation of the directives from the central agencies that each department should absorb cost increases within allotted funds. In both situations, however, the actual physical progress may be much less than scheduled and the overall outlays on the project be more than scheduled. These facts do not become evident when attention is focused only on annual outlays and money expenditures. Periodic reviews should identify the lags in physical progress, the areas where money expenditures are far ahead of the physical pace and the factors contributing to each. It is to be noted that reviews of this kind have not been undertaken and there is more often a general resignation that physical progress is bound to be inevitably less. Admittedly, such feeling of expressions of despair are unlikely to be of much avail unless they are channeled into constructive action. The only course available, however, is the periodic review, a grim determination to face the facts, and a search for alternatives within given parameters.
Expenditure and aggregate patterns

Another aspect that is not revealed in all its depth is the occurrence of budgetary variations with their impact on government policies. Progress of expenditure in comparison with budget estimates or physical progress in relation to that scheduled reveals a complete picture but may not show to the same extent the linkage with other aspects. Such interrelationships will be evident only when these data are supplemented by an analysis at the aggregate level. Analysis is of two types: (a) aggregate expenditure patterns and (b) aggregate analysis of other fiscal variables.

The experience of a number of developing countries reveals that, at an aggregate level, there is an excess of expenditures in the low priority areas and underexpenditure in the high priority areas. These are contributed by a combination of factors described earlier. While in a broader sense issues may be raised about the areas of low and high priority, the fact remains that governments arrange their priorities as seem fit. This high achievement where it is not needed, and low achievement where it is needed, naturally lead to distortions in plans and policies. As a result, planned investments will not materialize, revenues expected to accrue will not be generated, and meanwhile the general level of expenditures may show an upward surge. These issues cannot be solved at the implementation stage of the plan but they must be considered vital for improved policymaking.

Budget implementation devolves different responsibilities on the central agencies, whose concerns are both immediate and slightly remote. The immediate concerns are with the behavior of the fiscal variables such as revenues, expenditures, internal and external borrowing, and with the changes in the impact of these items on the economy. Major changes from expectations require action even during the course of the year while, in some cases, action may be feasible only in subsequent years. Periodic review involves a broad oversight on the specifics of expenditures of the agencies, as well as on aggregate fiscal variables.

**BUDGETARY TASKS**

The tasks of budgetary management comprise appropriate regulations concerning the disbursement of funds, the establishment of a
reporting system, and arrangements for processing supplementary grants. Each of these provide the means for some or all of the administrative and economic tasks described earlier.

**Regulating payments**

A significant contribution of the traditional budget system has been the series of vantage points provided in the implementation phase during which control could be exercised. Following the distinct duties of the teller, clerk of the pells, and the auditor, several checks and balances have been built into the system to (a) comply with the legal requirements, (b) secure prior review and approval in accordance with existing regulations, (c) conform with technical specifications, and (d) avoid maleficent acts and ensure propriety in the handling of public monies. The procedures necessary for achieving these goals are by and large common to all the systems, although they have been more formally specified in the French system, where payments by the Treasury (controlled by the Finance Ministry) are preceded by three consecutive expenditure control operations, executed by an official (ordonnateur) in the department where the expenditure is incurred. These are (a) commitments (engagements), which are initiated within the limits of budget appropriations, followed by (b) the verification of documentary evidence that the service was actually performed (verification) and the establishment of the exact amount of the claim (liquidation), and (c) the issue of a pay order (ordonnancement) to the Treasury, which, after a further review, arranges for the issue of a check or cash.

These procedures are well understood and preserved in government manuals and regulations. In implementation, however, there are degrees of institutional adequacy. In industrial countries, over the years, firm procedures have been established for the preaudit of claims and their payments. In some developing countries, particularly in some areas of Africa, very little progress has been made to establish well-staffed prepayment audit units despite the vast sums of money handled by spending agencies. Inevitably in such situations, delays, classification errors, and incorrect payments occur.

**Progress reporting systems**

Control, in its wider connotation, needs to be exercised earlier than at the penultimate points of payment. To this end, a system of
reporting is needed that effectively shows the progress of the budget. The objectives of the reporting system, in the light of the economic tasks discussed above, are to ascertain budgetary lags, to identify cost overruns, and to permit a quantitative and qualitative assessment of the work, in turn formulating a feasible corrective action where needed. From the early stages of budgeting to the most recent decades, the emphasis of progress reporting has been primarily on producing accounting data for the various categories of the budget.

For this purpose, the overall purview of the reporting system covers personnel, contractual services, and capital projects. The progress made in installing reporting systems in these areas is, however, by no means uniform. Personnel and contractual services have, traditionally, received most attention. Given the legislative pronouncements on the need to avoid excessive growth, it is only logical that more information is collected on the status of the personnel. Progress reports for personnel deal with the organizations, their subdivisions, classes, or grades, authorized and actual strength at the beginning of the year, additions approved, progress in recruiting, vacant positions, and pending personnel action, and are generally reported by the agencies concerned. Similar data are also collected on other items of expenditure, such as travel, transportation, utilities. Reports on contracts (for construction or delivery of goods) usually indicate the purposes of bids, relationship to programs, tenders received, and their current status. Separate reporting systems for capital projects are, however, relatively of recent origin. These reports, which are both general and specific (in that the features of each major project are taken into account), are normally derived from the control schedules of projects which, in turn, may have been prepared with reference to a variety of techniques such as Critical Path Analysis, Project Evaluation and Review Technique, Scheduling Program for Allocating Resources. Two major components of these reports generally are (a) schedule reporting and (b) cost reporting. The former refers to the project status report, which indicates the progress in the critical areas of the project. Cost reporting focuses more attention on minimizing the excesses over original project cost estimates and usually provides data on the nature and extent of cost overruns. For both components, the physical and financial progress, slippages, slack, changes in the completion data, and related aspects are reported.

The information systems are multifaceted and the above areas
represent only selected aspects. If systems are as well developed in implementation as they are in their conceptual framework, probably all would be well with government financial management. In practice, however, there are a number of drawbacks which again differ in their incidence. The reporting systems do not always reconcile the differing requirements of the central and spending agencies. In some countries, systems were primarily designed to meet the aggregate requirements of the central agencies, which are not suited to the requirements of the departmental managers. Even when they have been partly adjusted for the spending agencies, the bias is toward personnel or object class and their relationship to programs do not appear to have been given their due. Progress reports in practice are often chronicles of past events and, in the absence of goals, do not offer a viable basis for judging progress. Moreover, the impact of the improvements in progress reporting systems on the financial management system is not always clear. It appears that the considerable progress made in designing these systems has not been matched by their utilization and, as such, improved information has not necessarily contributed to improved policymaking. This is partly because the reports tend to become so elaborate that the operating official does not bother to report all the aspects. In his view this entails a disproportionate investment of his time. Another aspect is in decision making, where owing to lack of institutionalized procedures for utilizing data, the reports have not had much impact. One could take comfort in the old saying that while a horse can be prevented from drinking water it cannot be forced to drink. All that the innovators can do is to provide water, so that when a horse chooses to drink it may do so readily.

**SUPPLEMENTARY APPROPRIATIONS**

The need for supplementary appropriations during the fiscal year arises primarily for three reasons. First, it is one of the axioms of legislative control that amounts appropriated should be spent only for the purposes for which they were intended. This means that as new needs emerge requiring expenditures, the latter must be approved by the legislature even if funds are available from the previously approved budget. Second, many agencies do not have the details required for a full submission of the financial requirements for their projects. However, where political decisions have been made in their favor, in
principle, only token outlays are shown in the budget for legislative approval and during the year, when full data are available, supplementary appropriations are sought from the legislature. Third, they are also sought when the initially approved funds have proved to be inadequate. Traditionally, advocates of parliamentary control have viewed these appropriations as a breach of contract between the government and the Parliament and as a "diseased excrescence." Those who prefer the need for maintaining fiscal stability view them with alarm and consider them as concealed time bombs that threaten the balance envisaged in the budget. In a wider sense, however, supplementary appropriations are inevitable both because of the long lags between preparation and approval of the budget and because of forecasting errors. Every budget maker wishes for a stable world but as this is not possible, supplementary grants constitute a necessary back-up mechanism. Denying the use of such a mechanism would impart a rigidity that could be more harmful and could mean the abrupt closure of several programs or the exclusion of those that are needed. It would also mean the triumph of a technicality over the ultimate objectives of society.

The preferred alternative should be a better preparedness for meeting every eventuality. Contingency reserves and midterm mobilization of resources are among the instruments whose relevance has been considered in Chapters 8 and 9. From the point of view of budget implementation, the aspect that merits recognition is that the processing of supplementary appropriations involves reallocation of resources and, therefore, deserves the same care as the budget. In practice, however, these appropriations have become too frequent and are processed for each one as the need arises, or are processed toward the end of the year more as a formality for obtaining legislative approval. In both cases, the overall impact of these supplementary appropriations on resource adequacy or on the pattern of distribution of resources appears to have received less consideration. Inevitably, in such situations, budgets as implemented turn out to be different from those planned.

8Sir Hilton Young (1924), p. 65.
9The annual reports of the audit departments in commonwealth countries abound with examples of infructuous supplementary appropriations.
EVALUATION

The term "evaluation" has been interpreted in a number of ways and has been variously described as auditing, performance auditing, implementation review, and program monitoring. Evaluation can be both prospective and retrospective. The latter refers to the assessment of progress and impact, analyzing the reasons for success and failure and deriving lessons that, in turn, could contribute to the achievement of government objectives. The term is used here in this context. The ideas of control as described above and evaluation are not mutually exclusive. In fact, they are integral parts of the overall budget implementation phase. Evaluation is not a mere analysis of expenditure flows but is wider and comes into its own after expenditures are incurred. More specifically, its features are (a) an analysis of the objectives of each program, the approach to their formulation and target setting, and the adequacy of the system evolved for their implementation; (b) the examination of the effectiveness of the procedures and schedules used for the implementation of the budget; (c) an assessment of the impact of programs in the light of their objectives and analysis of the flow of benefits and their use; and (d) to ascertain the wastage of men, materials, and money. It is therefore larger than a routine financial audit. Unlike audit, which needs the specification of the funds and the objects of expenditure, evaluation involves defined goals and specific measures of impact. This would, inter alia, involve the establishment of the units of measures of productivity, costs, and of actual accomplishment. In other words, as a prerequisite, evaluation needs the availability of features or conditions associated with performance and program budgeting systems. Without them, evaluation would be substantially less than expected. These prerequisites are not as yet fully available and evaluation has therefore become selective, confined, as it were, to a few areas of government operations. The implementation of evaluation and reaping its full benefits, as practical experience shows, has not been free from some major issues. The first of these is the location of the evaluation authority; or more fundamentally who evaluates whom. It could be argued that if the authority is located in spending agencies, it could be used in a self-serving way and no programs would be conceded as failures. The spending agencies wish to show the results in a better light so that more funds can be obtained. This approach is in
conformity with the maximizing behavior of the agencies and the bureaus. However, location of the responsibility in a central agency may soon lead to the adoption of too critical attitudes, which may, in due course, deaden the initiatives of the spending agencies. It is also believed that the activities of some agencies are too specialized that central agencies are not able to evaluate them. An ideal solution would, of course, be to have evaluation systems within the spending agencies as well as to have the central agencies evaluate them. This would cause a certain amount of needless redundancy that many governments cannot afford. It is also likely that the final results of such evaluations may be too obvious or too negligible to warrant an enormous organization. Recognition of these factors has contributed to a variety of practices. In some countries evaluation is carried out by the spending agencies (Canada); in some the responsibility is with the President's Office (Latin America); and in some it is carried out as a part or an appendage of the plan organizations (India and Tanzania, for example). A second issue relates to the difficulty of specifying the criteria for evaluation. For most general services, such criteria are either not attempted, are too elusive, or require extensive statistical surveys for measurement. Finally, it appears that evaluation is not integrated with the budget cycle and the priority areas chosen for evaluation are frequently different from those emphasized in the budgetary process. Difficulty is also experienced in funding appropriate personnel for undertaking evaluation. Several of the programs require interdisciplinary approaches and related expertise that may not be available in government. However, following the tradition of the French Audit Court, some countries have often co-opted outside members and associated them with the evaluation exercises. Although the progress achieved is far from what might be expected, given the intractability of some of the issues, neither is it insignificant.

Cash Management

Cash management, which is a neglected area of budget implementation, has twofold purposes. First, to ensure that borrowing is well within specified limits and, second, to ensure that interest on debt is minimized. Both these aspects are neglected because of the practices of debt management, as well as the lack of consciousness of the cost of interest, in government. In several countries borrowing is undertaken
because limits for such borrowing have been specified in the constitution and because funds are needed anyway. Some borrowing is undertaken partly for the reason that some government-owned sinking funds, which are otherwise liquid, cannot be utilized for meeting cash requirements in view of legislative restrictions. Borrowing, however, has consequences for the conduct of general economic policy. For one thing, such sinking funds may mean the withdrawal of purchasing power from the community, which may be appropriate in conditions of inflation or excess demand but will have little relevance if the purpose of the policy is to expand demand. Similarly, if the objective of the authorities is to restrict credit expansion, and if governmental procedures permit agencies to hold balances with banks (either from sinking funds or other earmarked funds), they may have an effect that is contrary to policy aims. An extension of this situation is frequently witnessed in many countries when governments continue borrowing to finance their overall deficit, while some government agencies build up balances with commercial banks and induce credit to the private sector.

Interest as a cost is rarely recognized in government because of the way in which government is organized not to impose a penalty on those responsible for incurring interest expenses. Interest costs arising from ad hoc debt and cash management approaches are borne by the budget as a whole and are not allocable to government departments. This neglect is further exacerbated by the general concerns during the budget implementation stage that are more oriented to the release of funds and the delivery of services. It is obvious, however, that because of costs of interest and the associated consequences for economic policy management, more attention is paid to this crucial aspect.

Effective cash management would require, inter alia, assessment of the seasonality of revenues and expenditures, preparation of forecasts of cash requirements, and adoption of the portfolio management approaches to optimize the liquidity positions so that cash is available when needed. The opportunity cost of funds needs to be given the proper recognition and it appears possible, with the recent improvements in banking operations, that greater ease in cash manage-

10For a recent criticism of this lack of attention in Canada, see Canada (1979), pp. 145–50.
ment can be obtained. The interests of governments with budget deficits are not geared as much to invest idle funds as to minimize their own costs of borrowing, while the objective of governments with budget surpluses and liquid cash balances is to ensure a greater return for their monies. These approaches imply the need for more coordinated cash management, which, while being in conformity with monetary policies, is also financially sound.¹¹

¹¹The Canadian Commission recommended that the management of finances be conducted wholly by the Finance Minister, that governments' banking arrangements be placed on a competitive commercial basis, and that accounting methods be improved so that departmental costing systems gave proper recognition to the cost of borrowing.
CHAPTER THIRTEEN

Government Accounting and Financial Information Systems

Where is the wisdom we have lost in knowledge?
Where is the knowledge we have lost in information?
T. S. ELIOT. Choruses from "The Rock"

Government accounting has a long history and was practiced even when there were no organized budgets. Until the nineteenth century, the efforts in this regard were primarily oriented to double-entry bookkeeping but lacked a coherent theory. Later there was a move from bookkeeping to accounting that involved the measurement and communication of financial information, in addition to recording transactions. During the twentieth century further refinements were made in cost and management accounting and the accounting system as a whole developed to meet purposes that were diverse but all related to the decision-making requirements of a commercial entity. These requirements include pricing, valuations pertaining to the operational activities of the firm and its inventories, and provision of information for prospective investors and the public. These approaches have also had their impact on government accounting. By and large, however, accounting in government is often considered to be more routine than dramatic, in view of its basic nature being a process of recording data on stocks, flows, claims, and other government operations. Its role was viewed as essentially limited to taxation and revenue control and to the recording of commitments and disbursements. However, in relation to the formulation of fiscal policies and their periodic evaluation, the infinite details of accounting, the rules and routines, the plan, form, and structure of accounts and the associated documents all acquire
great meaning and interest and admittedly have a crucial role to perform. Notwithstanding the growth in the size and operations of the public sector, accounting systems in government do not appear to have received the attention they needed or deserved. As will be shown in the following sections, although many reforms have been introduced both in industrial and developing countries, their present status is such that, while they inspire confidence in recognizing problems and in efforts at solving them, there are still many issues that remain to be tackled.

**NATURE OF GOVERNMENT ACCOUNTING**

Many contend that there is no positive description of government accounting, although, from a negative point of view, there are several features that distinguish it from commercial accounting as well as from social accounting. Conceptually the differences between government and commercial accounting are at best marginal and some of the arguments seeking to distinguish them may appear to be lacking in logical validity. For example, the two main differences frequently pointed out are (a) the absence of a profit motive in government and (b) that managers in government primarily aim at complying with the legislature's wishes. The profit motive in government is applicable only to a few areas, while in the commercial sector profit is an expression of year-round activities. There is no (and there cannot be any) equivalent of profit in the government, although the concerns of government and the commercial world are the same in regard to the allocation and use of resources. The financial return in the commercial world may in some ways be considered to have a parallel in the social

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1 Nearly three decades ago, the United Nations observed in one of its studies that "In spite of the importance of government accounting . . . relatively little attention has been devoted to this subject in most countries in recent years." It added, "Even in developed countries, there have been surprisingly few up-to-date surveys of procedures for accounting, and budget control." These statements have a good deal of validity even in the current context. See United Nations, *Government Accounting and Budget Execution* (1952), p. 1.

2 See Robert N. Anthony (1980), pp. 83–93. Anthony contends that the existence of the two worlds of accounting is unnecessary and suggests that the financial statements of a government could also be constructed according to the principles that operate in the commercial world. Anthony was making a case primarily with reference to municipal governments.
return in government, with the major difference that the former can be measured while the latter can only be imputed. Similarly, observance of spending limits or compliance to the wishes of a higher body are not the unique features of government: these features have counterparts in the private sector when they produce goods or services under cost-type contracts or when they have to meet some standards specified by governments.

Although the basic principles of accounting are the same in both commercial and government accounting, it is in the application of some of these principles, and the institutional framework in which it operates, that government accounting stands apart. The commercial firm draws its revenues from the sale of services; in government income is derived from the use of government's coercive power to impose taxes. In certain areas goods and services are offered for sale but their proceeds do not constitute a major part of government revenues. The firm is managed by a board of directors representing the shareholders. Government is managed by the community through its elected representatives. In business the purpose of information is primarily to serve internal needs, and the information given to the public is to meet the investors' requirements or accountability to the community. The shape of accounts is molded by the purposes of the organization that it is expected to serve. In the government the purpose that dominates the approaches is that of accountability. There are other systemic differences too. In the commercial world double-entry bookkeeping continues to be the major theme. It aims at preserving the balance between assets and liabilities. Each transaction has a dual effect on the assets or the liabilities of the owner's equity. In a number of governments, however (excluding the Western European countries that were oriented to the cameralist approaches to accounting), such double-entry bookkeeping is not considered essential and accounts are maintained on a single-entry basis. Another difference is in the calculation of depreciation. In the commercial world depreciation is calculated over the life of the asset and is charged as an operating expense. If the overall sale proceeds are not equal to depreciation and other expenditures, it implies that the investment in the asset has not been recovered. In government, however, both for philosophical and

\[3\text{Credit and debit entries are, however, maintained.}\]
technical reasons, depreciation is not charged and the cost of services as reported is invariably less than the actual cost incurred.

Government accounting as it is today reflects the cumulative experience of several centuries and its components represent the growth of both accountability and management concerns. In the early stages, accounting was designed to show compliance with legal provisions and, together with budgeting, provided a system of financial management offering controls at various stages and delineating the role of those entrusted with the collection, custody, and disbursement responsibilities of public monies. Later, with the growth of audit as a separate function, accounts were required to be maintained to provide a full disclosure of the financial activities of government and a basis for an independent audit covering all the transactions and properties of government. With the growth of industrialization and reflecting the demand for more sophisticated systems of accounting, additional features were introduced to reveal the costs of activities and organization. More recently, and particularly since the 1950s, the requirements of economic analysis and development planning have made additional demands on government accounting. They are now called on to play an important role in economic planning, budgeting, rendering accountability, and facilitating evaluation. These purposes and the role of the various organizations in terms of production and end-use of data are shown in Chart 6.

FEATURES OF ACCOUNTING SYSTEMS

The system illustrated in Chart 6 may be considered ideal. The response to the tasks, however, varies. Broadly, following the analysis presented in Chapter 5, the accounting practices in many countries may be described in terms of those based on the British, French, and U.S. systems. Also important are the Latin American practices, which, as already noted, initially had a strong Spanish influence but which, in due course, developed their own hybrid systems.⁴ There are, however,
several variations in individual practices of countries among these
groups and the typology adopted here should be considered as a
convenient shorthand for grouping some common features. It should
be noted that the evolution of accounting systems in developing
countries did not necessarily follow the patterns experienced by the
older industrial countries; these systems have moved forward rapidly,
thus compressing the various phases into a shorter, single span.

The accounting systems have admittedly evolved with reference to a
corpus of funds through which government transactions are carried
out. In the British system, these funds usually are (a) a consolidated
fund through which all government transactions are channeled, (b) a
contingency fund, primarily an accounting entity rather than an
operational fund, utilized for meeting unforeseen expenditures pending
legislative approval, and (c) a public account in which monies are
held in trust. In the French system, the Treasury predominates and
maintains a type of universal fund for all transactions. In U.S.
practices, there is usually a general account forming the solid core of
the accounting system and also a number of other special accounts and
trust funds for meeting specific purposes. The Latin American
experience is more diversified in that there are some countries with
only a single fund, while others have a number of funds. A general
feature of all these systems is the maintenance of a unified cash
position, although in several Latin American countries, ministries and
agencies maintain their own cash balances separately.

Expenditures incurred from these accounts and revenues collected by
agencies are recorded in different ways in different systems. Revenues
are generally recorded on a cash basis. In a few Latin American
countries, however, they are recorded both with reference to the "due"
basis and to the actual payments in the year. Expenditures are variously
recorded. In the British and U.S. systems they are usually recorded on
the basis of checks issued or paid and on actual cash disbursements. In
the French system expenditures are recorded in two stages—by the
spending agency and by the Treasury—the former based on the
delivery of goods and services and the latter on the basis of actual

United Nations, *Government Accounting and Budget Execution* (1952), and P. J.
Van de Ven and D. J. Wolfson (1969), pp. 140-58. For Latin America and
experience of some parts of Africa, see United Nations, *Latin America's Experience in
the Use of the Public Sector Budget as an Instrument of Development Planning*
(1965a).
Chart 6. Government Accounting

Channels of data input

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<tr>
<th>Items</th>
<th>Organizations</th>
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<tbody>
<tr>
<td><strong>REVENUES</strong></td>
<td>Revenue departments</td>
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<td>Tax revenues</td>
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<tr>
<td>Nontax revenues</td>
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</tr>
<tr>
<td>Fees</td>
<td>Administrative departments</td>
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<tr>
<td>Administrative charges</td>
<td></td>
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<tr>
<td>Sales of services and products, etc.</td>
<td></td>
</tr>
<tr>
<td><strong>EXPENDITURES</strong></td>
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<tr>
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<tr>
<td>Indirect expenditures</td>
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</tr>
<tr>
<td>Grants</td>
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<tr>
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<td>Ministry of Finance</td>
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<tr>
<td>Domestic debt</td>
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<tr>
<td>External debt</td>
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Purposes and end uses

Government Accounting Systems

- Limited, intermediate or extensive fund systems
- Basis of accounting
- Accrual
- Cash
- Obligational

- Accountability and audit
- Legislative accountability
- Audit by external agencies

- Planning
- Development planning:
  - Sectoral allocations
  - Project appraisals

- Budgeting
- Tax policies
- Tariff determination
- Expenditure priority planning
- Debt levels and coordination with monetary policy
- Measurement of the impact of the budget, etc.

- Appraisal and evaluation
- Program management
payments. In Latin American countries various procedures are in vogue and are recorded with reference to obligations, payment orders, transfer of funds to spending agencies, delivery of goods, or checks issued. In the British and U.S. systems, a commitment or obligational system of accounting is also used for recording the placement of orders and future liabilities but this constitutes a separate administrative process and the final accounts reflect the payments.

Transactions recorded in the above manner are expected to be compiled and consolidated at specific intervals and reported at the end of the year. The year-end accounts, which are known as closed accounts, may not correspond exactly with the fiscal year of the budget. In the British and U.S. systems the annual accounts reflect the consolidated transactions of the year. Transactions are recorded on a chronological basis and those that occur after the cut-off date are included in the transactions of the following year. Some countries that are included in this group, however, adopt minor variations on the theme; for instance, a complementary period ranging from two weeks to a quarter of a year is permitted to complete the transactions. Although transactions are actually paid in the following year, the books of the previous year are kept open until most of these transactions are completed. In the French system, accounts are compiled on a calendar-year basis but are converted to a fiscal-year basis where this differs from the calendar year. In countries with systems modeled on French methods, three different practices are observed. First, there is a cash period system (règle de la gestion), under which all receipts and expenditures are recorded in the period in which they actually occur. These periods, which are coterminous with the fiscal year, do not permit any carry-overs to the following year. Second, there is a commitment system (règle de l'exercice), under which, in principle, revenues are recorded on the basis of collections and expenditures when incurred. However, at the end of the fiscal year, a further six months are allowed for the issue of pay orders and settlement of expenditures. Third, there is an extended cash period system (règle de la gestion prolongée), which is a modification of the cash period but incorporates a feature of the settlement of checks issued by restricting the complementary period to two months or less. The general validity of a government check is from three to six months and it is expected that most transactions are completed before three months.
experience of Latin American countries generally reveals a variation of the extended complementary periods, which in some cases range up to a year or more after the close of the fiscal year. This implies that, at any given stage, agencies have to maintain different sets of accounts for various fiscal years.6

The form of closed accounts and the extent of detail incorporated in them differ from country to country. In some (particularly in Latin American countries) voluminous detail based on straight ledger accounts is provided. In the British, French, and U.S.-oriented systems, final closed accounts are restricted to major categories of expenditures and reflect the pattern set by the legislature for approval of appropriations. The purpose of closed accounts is to serve the requirements of appropriation audit and to provide information to the public on the status of the government finances.

In the British-type systems, a balance sheet of the government is also provided. This statement reflects the changes in the cash holdings between the beginning and end of the fiscal year and changes in assets and liabilities during the fiscal year. Together with closed accounts, these balance sheets provide information on the transactions during the year as well as on the consequent changes in the financial status (including debt) of the government.

TOWARD MODERNIZATION

The accounting systems described above have lasted a long time—a feature that may be considered both an asset and a liability. They are an asset in that they have provided a degree of stability and have served (and continue to serve) the accountability purposes well.7 They are a liability in that the progress achieved in meeting the new requirements is perhaps less than expected. The issues of government accounting

6Cash outlays in a year do not necessarily reflect the liquidation of the liabilities incurred during that year.

7The effectiveness of accounting reports in this regard should not necessarily be judged in terms of the use made by the legislators for judging the government's performance. Indeed, if that were to be the criteria, conclusions may have to be different. The reports are put to greater use, however, where there is a legislative committee such as the Public Accounts Committee in the British system that formally considers the reports and submits its report to the legislature. It is fair to say that legislative enthusiasm tends to be more in the context of the proposed allocation of resources than in the review of their utilization.
need to be assessed in terms of what they are expected to do in the contemporary setting and what they have so far been able to do. It is in the process of contributing to the recognized purposes and end-uses illustrated in Chart 6 that a number of shortcomings of the systems have been recognized and improvements sought. The improvements aimed at making the systems more effective by meeting the accountability, management, and planning requirements and by covering the whole gamut of accounting approaches and procedures and institutional arrangements. Significant aspects of these improvements, their aims, and effectiveness are considered below.

**Basis of Accounting**

The basis of accounting traditionally has been cash. The choice of this basis was appropriate in view of the attitude toward loans by government and related increases in public debt. Prudent financial management was then equated with a balanced cash position. Over the years, reflecting the importance of fund control and the measurement of costs incurred in rendering government services, two other bases—obligation and accrual—were advocated and used in governments. The use of these terms and their actual implications were not free from some semantic confusion and it is appropriate that the nature of each is specified first before their relative advantages are considered.

The basis of accounting can best be illustrated by the actual phases of budget implementation shown in Chart 7. In the sequence of administrative steps, it will be observed that the first step of spending agencies toward the utilization of appropriated funds is to place orders for the goods and services needed during the year. Such orders, which result in incurring obligations, can be placed at any time during the fiscal year. Accounts when maintained with reference to this point in time are known as obligation basis and refer to a system where recorded transactions represent commitments to acquire materials or services or to make payments under specific conditions and include orders placed, contracts awarded, and related transactions requiring money disbursements, usually at a later date.⁸ The next stage in the administrative

⁸Often, obligation basis is confused with accrual accounting in that the former also aims at recording the liabilities incurred. There are, however, two major differences. First, obligation basis is usually restricted to outlays, while accrual includes both
process is the acquisition of goods and services, which is also the accrual basis of accounting. Accrual accounting has, however, been variously defined and described. In certain instances, it refers to a system of accounts where revenues and expenditures are recorded as they are incurred or earned. It is also described as a system where there are long complementary periods to record the completion of earning revenues or incurring expenditures that were originally included in a budget or a related financial statement pertaining to the fiscal year. The term is also used to denote transactions that are of an obligational or administrative approval type. In a more precise manner, accrual accounting is seen to be a system in which revenues and expenditures are recognized as they are earned or incurred, regardless of when receipts and outlays. Second, accrual basis refers to the receipt of funds, property, or services within a given period of time, usually the fiscal year. Obligations refer to the orders placed and contracts awarded that will result in the disbursement of money at a later stage.
payment of expenses is made or when income is actually received. Specifically, this means recording receipts at the time they are due and expenditures at the time liabilities are incurred as a result of services rendered or, for mass-produced "shelf" items, when the goods are delivered. This therefore reflects the resources available to government and the actual receipt of goods and services. As integral parts of this system, two more concepts are used—accrual expenditures and program costs. The former refers to the monetary equivalents of goods received, services rendered, expenses incurred, and assets acquired regardless of when payment is made. The latter refers to the costs of goods and services actually used in the implementation of a program. The main distinction between the two is that one measures the resources acquired, while the other measures the resources used. The final step in the process is the payment for services and goods received and the cash system of accounting that relates to this phase refers to a system in which receipts and expenditures are recorded at the time cash is received or paid out.

The features and the relative superiority of each system has been a source of debate over the years and there are several schools of thought, each one advocating a particular basis as an ideal one for governments. Obligational basis is viewed as a very useful tool for fund control and as providing a midway base between legislative appropriations and actual payments. Since at any given stage of budget execution it fully indicates the liabilities incurred and awaiting liquidation, it also better serves the requirements of financial management. Moreover, in terms of budgetary flexibility for managing aggregate demand during the

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9The actual use of accrual in the compilation of national accounts is different and various bases are used for different transactions. For example, the European Economic Community, European System of Integrated Economic Accounts (Brussels, mimeo-graph, 1971) specifies nearly 40 transactions indicating the bases such as delivery, due, availability to the producer (pp. 190–95). In the United Nations' System of National Accounts (1968) taxes are to be recorded when they are “due” to be paid. It was recognized that the “due” basis of recording certain transactions such as indirect taxes and subsidies, the obligation or the point of time at which it is earned or incurred may arise at a different point of time than when it is due. It was, however, hoped that the discrepancy involved would not be large (p. 123). Unrequited current transfers are recorded when they are made, while other expenditures are recorded as of the date the goods enter government stocks. In the compilation of U.S. national accounts, transfer payments, subsidies, and grants are recorded on a checks-issued basis, construction on a put-in-place basis, and goods involving long lead times on a physical-deliveries basis. Similar adjusted practices are found in other countries.
fiscal year, the obligation system provides a better basis for control for either increasing or reducing expenditures. This purpose cannot be served by the accrual or cash systems, as they reveal a transaction after it has occurred. In a context where the need is to have a greater grip on the aggregate volume of government contracts and related obligations, this system has certain advantages over the others. Its main limitation, however, is that it lacks the capability for measuring the costs of programs or the performance of departments. In practice very few countries maintain accounting systems that are exclusively obligation-oriented, they are generally combined with cash accounting. The separation of organizational responsibilities in some countries is such that the full benefits of a combined system are not realized. Spending departments usually maintain accounts, in such cases, on an obligation basis, while the central payment offices compile accounts on a cash basis. More often than not, the former may be unaware of the latter's action, whose responsibility does not include a watch over obligations. In governments where both functions are combined in the spending agencies, the benefits are admittedly more.

The system of accrual accounting gained increasing advocacy during the 1960s from national income accountants and managers. The former view it as the best measure of the impact of the budget as it indicates the time when the government actually incurs a liability or registers a claim.\textsuperscript{10} It is for this reason that the accrual basis is used in the compilation of national accounts. The conceptual offshoots of the accrual system—accrual expenditures and program costs—facilitate the identification and performance of the various work units and therefore could better serve the overall purposes of budget formulation and program management. This approach formed the basis for the advocacy of accrual systems as an integral part of performance budgeting approaches.\textsuperscript{11} Moreover, it will speed up the compilation of national accounts. The advantages of cost measurement and better links with national accounts are conceded by all, but as the "best measure" of economic impact, however, they are disputed. It is, for

\textsuperscript{10} The President's Commission on Budget Concepts concluded "that accrued expenditures are the best measure, since the accrual is the point of final commitment which has the largest and most direct economic impact on the private sector," United States, \textit{Report} (1967a), p. 38.

\textsuperscript{11} For a discussion of these aspects, see United Nations (1952) and (1965).
example, difficult to decide exactly when claims or liabilities can be said to have influenced the community's economic decisions. It could also be argued that the community anticipates the actions of government and may be prepared to provide goods and services from its stocks. Indeed, in matters of sophisticated technology, the availability of goods may induce demand from the government rather than the reverse. The accrual system, however, is capable of recognizing unpaid claims or liabilities to the government which other systems cannot.

The cash system has long been a favorite of economists and of some accountants. The case for the system was crisply stated by Seymour Harris: "Its strength lies in its comprehensiveness, in its tie-in with operating statistics, and its relevance for revealing economic effects of the budget." It permits an easy identification of the impact of government operations on the economy as actual payments made by government tend to increase the money supply and activate the economy while each payment to government decreases the liquidity. A cash-based concept of budget deficit, as noted in Chapter 3, provides a meaningful assessment of the impact of government operations on demand management. It also facilitates the analysis of the impact on financial and credit markets. The government as a "banker" should know its own cash position and cash accounting permits this to be easily assessed. It is also more comprehensive than national accounts, as cash-based systems include loan transactions, which are excluded from the national accounts. Accountants and administrators have supported the cash system because of its administrative simplicity, convenience, and minimum expense, but the system has some limitations. First, as noted above, all noncash transactions, which sometimes are quite sizable, are excluded. Second, cash flows do not fully reflect management requirements, particularly in major projects. These flows contribute to an implementation illusion when physical progress is not congruent with financial progress. In those situations cash flows may overstate the project costs. Conversely, when large payments are made after a project has been completed, it understates the costs during the years preceding the completion of the project.


Cash flows also have limited usefulness in the measurement of changes in inventory.

The different approaches should not be viewed as mutually exclusive but are better considered as essential elements that have a place of their own in the overall system. The distinction between some systems may not even be significant. For example, in some cases, such as services, there is unlikely to be any difference between the incurring of a liability (accrual) and its payment (cash). The differences would be sizable during periods when there is a rapid increase or decrease in outstanding government orders for procurement of items that have a long lead time. Whatever the nature of accounting basis, it would not be difficult to obtain other types of data. For example, in a cash system, disbursements minus increase in outstanding advances plus increase in accounts payable would equal accrued expenditures. In regard to obligations, the total of such commitments minus increase in undelivered orders and unperformed contracts would equal accrued expenditures. Accrual basis is also vital for the computation of costs and has a legitimate place for as long as budgeting involves the measurement of costs. It is, therefore, appropriate that the existing cash systems are supplemented with features of obligational and accrual accounting in selected areas.

The need for converting government accounting into accrual-based accounting received substantial stimulus in some industrial countries, specifically the United States in the early 1970s. This advocacy was only natural given the efforts to introduce performance budgeting in government over a prolonged period. Also, the long-standing experience of the Netherlands, which had had accrual accounting for several years, sparked a good deal of enthusiasm for the introduction of similar systems elsewhere. But progress in its introduction was slow. Implementation problems, cost of the systems, and the growing influence of demand management as a policy goal contributed to this. The accrual system also gave rise to some tricky conceptual issues. For example, for corporate income taxes, the accrual system could be more volatile and a time lag between accrual and payment of taxes could produce sharp differences between their actual and apparent impact. Also, in some cases, the recording of taxes when due generate a degree of false complacency and induce new expenditures. When actual payments of taxes fell short of the accrued estimates data, increased deficit financing was resorted to in order to balance the budget. The...
accrued basis had limited applicability for the bulk of transfers to other branches of government where services accrued to the grantees. Also, it posed a problem in the assessment of work done (in lieu of delivery) for which progress payments are made over a period. The approach suggested for this purpose is the technique of constructive delivery, under which expenditures are reported with reference to the work actually performed to government specifications. However, this implies resorting to imputations which, by their very nature, cannot be consistent and thus cannot be free from controversy. The introduction of the system also entailed significant additional cost and deployment of skilled manpower and it was not evident that the system needed to be given an overriding priority. More significantly, the whole effort seemed to have suffered a setback owing to the increased emphasis on the measurement of the budget impact and the advantages that cash system had for the purpose. In fact some countries, notably the Netherlands, switched to a cash system in 1976. The introduction of congressional budget procedures in the United States also emphasized the cash basis for purposes of determining budgetary ceilings. In the process, the selective application of accrual accounting in government reached a state of hiatus. Some believe this reflects the triumph of policy requirements over program management.

**FUND STRUCTURE AND CONTROL**

Another important area that has received a good deal of attention relates to the increasing proliferation of funds and the problems of their control. Although in previous years governments tended to transact through a consolidated fund or its equivalents, over time, with increasing resort to expedients, and a growing practice of providing autonomy to certain agencies, the corpus of funds widened. In addition, the prevalence of practices such as back-door spending, borrowing without legislative approval, and contract authority tended to encourage a greater spread of funds.\(^4\) The existing fund structures

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\(^4\) Back-door spending refers to congressional authorizations to spend from debt receipts, while contract authority refers to powers delegated to certain agencies to incur obligations without prior enactment of enabling laws by the legislature. Variations of these practices are found in a number of industrial and developing countries.
in some countries may broadly be classified into limited fund systems (5 or less), intermediate systems (5 to 20), and extensive systems (more than 20). Data on the fund structures of 19 selected Asian and African countries are given in Table 24. (The table does not include social security funds or such funds as are operated by autonomous agencies but essentially reflects those that are managed as a part of the budget.)

Experience of certain countries indicates that there is an inverse relationship between the number of funds and the exercise of financial controls. In theory it could be argued that extensive fund control systems imply an undue fragmentation of maintenance of accounts and consequent increase in the span of controls. Further, when funds are extensive, difficulties can be and are experienced in the consolidation of accounts, particularly because of (a) problems in the identification of relevant accounts and elimination of double counting, (b) absence of uniformity in classification practices in the funds, and of (c) different practices for fiscal years and complementary periods. Book adjustments, reconciliation of accounts, and clearance of suspense accounts (techniques that are followed in government when more than one account is operated) appear to contribute to long delays in the compilation of accounts. Creation of these extensive funds appear to have yielded only minimal benefits in terms of managerial autonomy and, as these funds proliferated, the loss of control overshadowed the benefits and some countries have had recourse to consolidation and recentralization of accounts. This effort is by no means uniform and paradoxically there are countries where the fund structures widened because of political factors and difficulties in obtaining legislative approval of budgets.  

**Classification**

The policy and program requirements of budget management necessitate that accounts also follow the same structure as in the budget. The various aspects of budget structures have already been

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15 In most industrial and Latin American countries, social security funds are numerous and there is a separate fund for each type of benefit (unemployment, sickness) and for each group (adult, children).

16 The experiences of Mexico, Bolivia, and Costa Rica illustrate this aspect. For a more detailed discussion of these countries' experiences, see James W. Wilkie (1974).
Table 24. Structure of Government Funds in Selected Countries in Asia and Africa

<table>
<thead>
<tr>
<th>Country</th>
<th>General Fund Account</th>
<th>Special Fund Accounts</th>
<th>Revolving Fund Accounts</th>
<th>Debt Retirement Fund</th>
<th>Sinking Funds</th>
<th>Deposit and Trust Funds</th>
<th>Total Number of Funds</th>
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<td>137</td>
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Source: Compiled from Annual Accounts of the above countries.

1Limited to central government.

2Includes, in some countries, contingency funds maintained as accounting entities.

3The data are not complete as trading accounts maintained by the agencies are not always centrally consolidated.

4Separate sinking funds are maintained, in some cases, for each debt issue. For this purpose, however, they are considered as a single entity.

5Includes extrabudgetary funds.

discussed in Chapter 10 and the progress made has been noted. It is to be expected, therefore, that there has been similar progress in the organization and presentation of accounts. The experience of several developing countries in Asia and Africa reveals some snags, however. First, in some countries where program classification has been introduced, appropriation structures (reflecting the items for which
funds have been provided) continue to be oriented to objects. As the orientation of accounts is primarily toward legal accountability, this followed the object classification and contributed to a data gap that is structural in nature and cannot be bridged in the interim periods. As an extension of this, it is observed that even in countries that have not had any similar problems, accounts continue to provide only major aggregates and have not, therefore, been useful in making data a functioning tool in the formulation and assessment of policies. This lack of progress in accounts has contributed to a situation where the traditional feeling was confirmed that accounts represent a culture alien to the administrator.

Related aspects are the identification and classification of trading activities in government accounts. Government activities include several areas where the approach is more commercial in nature. Most departmental activities include the sale of goods and services and examples of this range from the sale of liquor or food to the provision of water for irrigation purposes and the operation of airports. The application of conventional accounting approaches does not reveal the commercial nature of these activities.\(^\text{17}\) In order that the true financial status and the prospects for viability could be revealed, commercial accounting would be necessary and would involve the preparation of pro forma commercial accounts. However, this continues to be an area where more progress should be made.\(^\text{18}\)

\(^\text{17}\)This is by no means a new problem. J. R. Hicks observed in 1948 "We have reached a point when it is hardly too much to say that this traditional structure (accounting principles evolved primarily as a solution to the problem of control of finances) is in a state of ruin. The ruin is partly a result of the war—it has always been difficult to enforce the traditional principles in war-time—but to a large extent, the causes lie deeper. The main reason for the collapse is the development of trading services which will not fit into the traditional categories." He added "to apply the conventions of the traditional Exchequer accounting to these trading services makes nonsense."

\(^\text{18}\)The General Accounting Plan evolved and implemented in France since the late 1950s was a step in this direction. Its application was restricted to publicly owned enterprises and to firms receiving government subsidies. It was less applicable to trading activities covered in the budget. General Accounting Plans of the French type were later introduced in other European countries and, during recent years, efforts were being made by the joint organization of African, Malagasy, and Mauritian States to introduce similar accounting plans. See Common African and Mauritanian Organization (OCAM), General Accounting Plan (1973).
POLICY ACCOUNTS

The overall purposes of government accounts have increased considerably with the addition of responsibilities relating to economic planning. The broad requirements of economic planning can be divided into two groups—those relating to planning per se and those connected with more specific aspects of budget and fiscal management, such as coordination with monetary aggregates in the pursuit of debt policies and the measurement of budget impact. The latter aspect is discussed in the concluding section of this chapter.

The requirements of economic planning include data for the preparation of project, sectoral, and national plans and, in each case, the efforts are devoted to a systematic and quantitative description and analysis of the structure and activities of an entity, a region, or an economy during a certain specified period. Over the years social accounting has been developed to meet these diverse purposes. Social or national accounts are different from government accounts in approach, scope, and structure. For instance: (1) Government accounts are limited to the entities reflected in the government budget, while national accounts aim at providing a coherent overall framework for presenting the main stocks and flows relating to national production, consumption, accumulation, and external transactions of the country. (2) Government accounts represent the starting point for the compilation of national accounts insofar as the government is concerned. Thus, government accounts represent the primary data. (3) National accounts aim at measuring the country’s production and its utilization by sector and category of goods. Government accounts are relatively narrow in scope and are primarily intended for planning, control, and accountability of government operations. (4) In their operational framework, national income accounts involve a wide variety of imputations, while government accounts aim at hard facts. Both systems deal with stocks and flows but in government accounts the emphasis is more on the flows. Notwithstanding these differences, congruence between the two is essential.

The patterns of use of government accounts, as well as those of national accounts, are clearly different in industrial and developing countries. In industrial countries, the development of national accounting took precedence in the 1950s and 1960s. As demand management became a major policy goal, efforts were made to improve
government accounts— in structure and classification, to harmonize better with national aggregates, and to better serve the requirements of policy formulation. Differences still arise between the two systems in areas where imputations are made and in cases where accounting systems are on a cash basis.

The basic framework for economic policy in industrial countries is generally that of national accounts. In developing countries the development of national accounts was a matter that involved a sustained effort over a long period. Specifically, in the context of meeting the requirements of economic planning, three types of views were advanced for data priorities. A typical view of the statistical offices was that, as macroeconomic estimates can only be as good as the basic data used, the priority should be to strengthen the basic statistical series. The second view (that of the planning agency) recognized that planning could not be postponed until all the aggregate series designed by statistical offices became available. For immediate purposes, greater priority should be given to the development of national accounting. The third view was that of the decision maker, according to whom there was a divergence between the actual needs of data and the ambitious proposals of statisticians and planners. The systems of planning were not complex and for day-to-day purposes emphasis could be on using the existing statistical sources. It is not surprising that the views of the last category prevailed and reliance was placed on statistics that ranged from organized guesses to randomly collected facts. To some this may appear as a heroic act of faith, while to others it was simply being reconciled to the inevitable.

Even within the above framework, greater attention to the improvement of government accounts was expected but did not materialize during the 1950s and through the major part of the 1960s. Accounts continued to serve traditional functions in the usual way. To the extent that the requirements of planning revealed the true nature and significance of government activities, it can be asserted that this was not so during this period. It was only in the late 1960s that

19 During the 1960s when national accounts were frequently revised to take into account wider coverage and improved classifications, it was likely that economic data might not have fully served the policy purposes. For a study of these aspects and their impact during 1955–69 in the United Kingdom, see P. D. Balacs (1972), pp. 35–50.

reforms for modernizing the budget, and thus accounting structures, were begun in developing countries. Measurement and evaluation of costs was, however, another matter.

**Program Management**

Management considerations in government vary with operations and the levels in the administrative hierarchy. The requirements and responsibilities of a project leader are obviously different from those concerned with the management of some revolving funds and from those at the top who are responsible for a broader range of activities. Despite these differences, an accounting system has to function in a manner that reflects the changing nuances. The broad objectives of accounting systems in the current context may be stated as primarily a concern with costs. At the middle level, managers are concerned with the measurement of costs and are responsible for reducing them. At the top-level management, the same concern is manifested in a slightly different way; their need is for reliable accounting data related to the performance and cost of such performance in regard to responsibilities entrusted to agencies. At the national level, the imperatives of fiscal policy transcend the economy and efficiency of programs and projects and are oriented toward the overall pattern of the use of resources and their costs and benefits.

In recent years, development of cost data in government has become quite sophisticated. In the current context, two approaches are utilized in government: (a) responsibility accounting and (b) cost finding and cost analysis. In the former approach, all outlays are charged to a responsible organizational unit as applied costs for its uses. The responsibility cost indicates the costs and results of operations by organizational units. The latter work within the framework of responsibility centers and provide the means by which the underlying responsibility and costs are summarized, rearranged, and analyzed. Both measure costs and together provide a perspective of a program and an organizational level. Measurement of costs is expected to include not only the use of materials acquired in an accounting period but also the use of assets that were acquired in a previous period. In an ideal setting this task would require the adoption of accrual accounting. In practice, however, some progress was made through ad hoc
techniques to measure costs or their proxies even when there is no organized accrual system.

In industrial countries considerable advances were made in the measurement and control of costs for defense, education, and health. Major progress was also made in establishing cost controls on large projects. In developing countries progress has been limited to major projects and much remains to be done in terms of accrued costs. Thus, the very role that accounting should play in program management remains to be fully utilized. The task of accounting is to move in the direction of certainty and measurement.

INFLATION ACCOUNTING

The emergence of inflation as a worldwide phenomenon has contributed to efforts on both sides of the Atlantic to promote appropriate revisions in the accounting framework to reflect changing prices. Specifically, in the commercial world inflation revealed the wide gap between accounting profit measured in terms of the difference between changes in assets and changes in liabilities at historical cost, on the one hand, and business profit measured as the difference between changes in current value of assets and in current value of liabilities, on the other. The recognition of these factors and the extensive debate that followed on the manner in which they should be treated contributed to two major accounting approaches—Current Purchasing Power (CPP) and Current Cost Accounting (CCA). The features of these approaches may be noted before considering their applicability to government. Under the CPP method, published company accounts are adjusted with reference to an appropriate index that would measure the decline in the purchasing power of the monetary unit and enable comparisons to be made with the historical cost figures used in the statutory accounts of the company. The CCA, as envisaged by the Sandilands Committee, adopted the concept of revaluing at their business value physical assets such as plant and machinery. The CCA approach was partly modified in some cases and emphasis was placed on the current replacement cost of specified items as substitutes for historical costs. Both approaches have limitations:

\[21\) United Kingdom, Report of the Inflation Accounting Committee (1975c).
\[22\) For an illustrative application of these concepts, see Sidney Davidson, Clyde P. Stickney, Roman L. Weil (1976).
one did not take into account the changing value of money, while the other was simply an updated version of the historical costs in which the changing values of different assets were not given proper recognition. The approaches had focused largely on adjustments to physical assets and ignored the effects of inflation on monetary assets and liabilities. A new approach that had more limited aims but was still known as current cost accounting was adopted in the United Kingdom. In this approach, three adjustments are made to the financial statements computed on historical cost basis: (a) depreciation, (b) cost of sales, and (c) gearing. The first two adjustments aim at raising the historical costs to current costs, while the third adjustment is to account for loss of purchasing power or gain in net monetary assets and liabilities. The depreciation adjustment allows for the impact of price changes or, more simply stated, for the difference between depreciation based on the current cost of fixed assets and the depreciation charged in historical cost computation. The cost of sales adjustment allows for the impact of price changes when determining the charge against revenue for stock consumed in the period. In practice, this implies the use of a specific index factor to revise the historical costs of opening and closing stocks of the year to compute the cost of sales. Gearing adjustment is concerned not with operational results, as is true for the other adjustments, but with the pattern of financing the operations. Company operations are financed by equity and borrowing. In a context of price increases, the value of assets exceeds the borrowing that has financed them. During an inflationary period the existence of such borrowing benefits shareholders (when the assets are used or sold) and offsets the cost of servicing the borrowing. Where the assets of the company are completely financed by equity, all inflation-related cost is charged to the profit and loss account of the company. These principles are now applicable to companies in the private sector and to enterprises managed by government, except that gearing adjustments are not considered necessary for nationalized industries in the United Kingdom in view of the special nature of their capital structure.

The relevance of the above approaches to government has not received much attention, except in Sweden, because of the widely held

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belief that in government there are no profits that are overstated,
dividends declared, or taxes paid. Such a view, however, is admittedly
narrow. The operations in government are more diversified and the
need for the introduction of appropriate adjustments for inflation can
be argued on several fronts. First, there is a need for symmetry in the
approaches used for resource allocation, as well as for resource use. It
has been suggested earlier that if budgetary forecasts and related
demand management are to be purposeful, the rate of inflation should
be forecast and relevant price indices should be used to formulate
expenditure estimates for government programs. A logical extension of
this is that the use of the resources should also reflect their current
value in relation to the overall claims on the community’s resources.
Sensible drivers cannot afford to spend all their time gazing into the
rearview mirror of historical costs. A well-informed budgeteer needs to
know the current position and not just the obsolescent data contained
in conventional government accounts. Second, cost consciousness in
government requires that costs be stated in current terms. Stated in
historical terms, they will not indicate the type of effort needed for
containing costs. As long as program controls are oriented to cost­
based estimates, it cannot be expected that historical-cost schedules
will provide the requisite road map. Third, governments have been
acquiring, over the years, a vast range of assets that range from huge
agricultural machinery to sophisticated equipment in various areas.
Traditionally, these assets were not taken into account in the
computation of costs. Although this conceptual gap has been overcome
in some industrial countries (notably in the United States and
Sweden), in developing countries very few governments have a
comprehensive inventory of these assets or compile data on their
valuation, longevity, or the cost of their replacement. In addition,
there is a clear need to develop and apply asset accounting where assets
are acquired to provide common services to other government agencies
(e.g., printing) or where capital has to be maintained intact to
maintain the credit standings of a government. Such asset accounting
should reflect the current costs if the overall cost consciousness in
government is to be improved. As the report of the Swedish Budget
Commission noted, all appraisable assets should be recorded by the
agencies and should be appraised on the basis of the replacement value
adjusted for depreciation.\textsuperscript{24} Such explicit recognition and supporting accounting procedures would go a long way in the acquisition, maintenance, valuation, and replacement of assets and should contribute to economies in public expenditure. Fourth, the basis of government accounting for services that attempt to recover their costs should be changed if the tariff is to reflect the current costs.

There are other views that have traditionally been advanced against asset accounting in government. As recognized earlier in the context of the discussion on current and capital budgets, one view is that asset accounting with its attendant features of financing and depreciation can make complete sense only in a commercial context and not in government. It would certainly be inappropriate to require the capitalization of every government asset and the costing of its use through the application of current cost accounting, by depreciation, or by any other method. There are several types of assets in government which clearly rule out the application of the above principles. However, there are many assets dedicated to productive activities in government where management cost data are incomplete and their usefulness seriously impaired without the inclusion of depreciation in accounts and reports. The argument for current cost accounting is relevant for these productive or trading activities and should not be considered as having governmentwide applicability. It is also suggested that the application of the above principles assumes the existence of an already well-established system and that, even then, the revised system would make further demands on personnel. On balance, a selective application, implemented over time, appears to be more feasible. If governments are serious about cost economies, there seems little alternative but a long-term commitment to revise their accounting systems.

\textbf{Organizational Aspects}

A vexatious question that has perennially haunted those responsible for designing government accounting systems is the location of the agency responsible for the collection, consolidation, and maintenance of accounts. Experience indicates that there is no single system and

that there have been at least three approaches. One was to combine the accounts and audit function into a single agency located preferably outside the normal departmental framework of government. The second was to have a central accounts department within the government and make it responsible for the maintenance of accounts. In this system, some minimal accounts would also be maintained by spending agencies. The third approach was to disburse accounting responsibilities to the spending agencies but to maintain a small central department for coordination and consolidation purposes. The first approach is basically found in Bangladesh, India (until 1974), Pakistan, Colombia, Chile, Ecuador, Peru, and Venezuela. Bolivia had a similar system until it moved to the second system during the mid-1960s. In several ways the first system is more a historical legacy, but its continuation or abandonment has always been fiercely debated and there have been many emotional overtones to the argument. Some consider it an irrelevant practice. Some view it as a practice that, however questionable, has gained a legitimacy of its own by the sheer virtue of existence. These aspects may be considered in detail here.

In India a feature of colonial rule was that the responsibility for accounts and audit was combined in a single office. Although it was recognized that the audit should generally be independent of the executive and accounts, a feature that was enshrined in the 1866 Exchequer and Audit Act in the United Kingdom, it was felt that the existence of an independent audit would undermine the effectiveness of government in a colony. Many efforts were made during the years 1880 to 1974 to separate accounts from audit, and selective experiments were also made in central departments and in some states with a separate accounts organization. The final separation was only achieved in 1974. Bangladesh and Pakistan, which shared the same administrative legacy, continue to have combined audit and accounts agencies, while Sri Lanka, which was a part of the same colonial rule, always had a separate audit department and accounts were maintained by a department within government.

The Latin American tradition appears to be primarily based on the considerable role assigned to preaudit in the Spanish system. Accountancy and audit were both encompassed in the accountancy profession.

21 For a more detailed account of these aspects, see A. Premchand (1966b), pp. 349–66.
and great emphasis was laid on the accountability for the obligation, receipts, and expenditure of funds as a significant part of this tradition. It became a more formal entity in the 1920s and 1930s, as a consequence of the recommendations of groups of experts under the leadership of Professor Kemerrer of Princeton University. Under this system, both accounting and auditing functions are carried out by a Comptroller General (Contraloria), whose office preaudits all expenditures, maintains central accounts for the government, and postaudits the transactions.

The key element in the above type of systems is the combination of accounting and auditing responsibilities in the same agency, which is located outside the executive. While there is no definitive school of thought that advocates the combination of these functions, several arguments that have the same purpose in view can be gleaned from experience. First, the combination of duties does not necessarily prevent the performance of functions that are legitimately a part of the responsibility of spending agencies. The agencies are responsible for watching expenditures and ensuring corrective action in time; while the function of the accounting and auditing agency is primarily to check the legal and financial requirements of expenditure. Second, the independent agency's audit does not necessarily imply that it is auditing its own accounts as much as it is auditing the use of resources by the spending agencies. Third, the accounts, if prepared by the spending agency, may not be reliable as the latter is an interested party. A detached agency can have more objectivity in compiling accounts. Fourth, accounting and auditing are interrelated functions and, when combined, provide unique access to data that an independent agency may not have. Finally, the question is raised whether there is much to be gained by disrupting a practice that is well understood by the participants.

The need for the separation of accounting from audit can be argued in terms of the managerial requirements of agencies, as well as the nature of the audit responsibility itself. Financial management is no

26 Various terms such as control previo, control preventatio, control a priori, fiscalization previa are used to denote preaudit.
28 For a historical survey of these arguments in India, see A. Premchand (1966b), pp. 365-67.
longer viewed as a process concerned primarily with the authorizations for spending but includes the wider functions of financial planning and the effective use of allocated resources. This function cannot be fulfilled if accounting is divorced from program management. Indeed, when it is separated, administrators merely become custodians of various pockets of money and the policy and program functions of the budget would not in any way be well served. Acceptance of the argument of maintenance of tradition would require a substantial amount of faith in a static society. Such belief is, of course, a negation of the concept of progress. Viewed from the audit point of view, a cardinal principle in the commercial world is that business transactions should be subjected to the scrutiny of an independent agency. Moreover, an audit agency that is free from the work of routine accounts can bring to bear a more detailed view and will have opportunities to concentrate on matters of greater importance.

There are other important operational effects that merit recognition. As a result of centralizing accounting and combining it with audit, the procedures relating to payments to the public appear to have suffered. Payment of taxes have been made easier, over the years, with a growing reliance on the banking system. But refunds of tax payments and pension payments have been rendered difficult because of the centralization of these responsibilities in the accounting and auditing offices. It would be normal to expect that, in dealing with the public, greater care would be taken of this phase. Experience belies these expectations. Moreover, even in dealings with government agencies, centralized systems of preaudit and related payments appear to have contributed to procedural delays and associated inconveniences. Once accounting is separated from the purpose that it is expected to subserve, it appears to have become an end in itself. Many financial checks are applied mechanically and adherence to formalistic procedures gains precedence over other matters. This is nor, however, to suggest that such controls should not be applied at all. What is stressed is that the application of these controls should not imply a triumph of technique over purpose. Yet another area where difficulty is experienced is in regard to the administration of civil service rules and in the maintenance of provident fund accounts of government employees, which traditionally were entrusted to the accounts offices in British Commonwealth countries. Here again dilatory procedures, duplication of work, and excessive paperwork have all contributed to
avoidable inconvenience. To sum up, the combined systems do not appear to have served well any part of their clientele. Government departments, the public, and civil servants are all adversely affected by these arrangements. The unsuitability of the system is recognized and, while some countries have successfully reversed the situation, it continues in a few countries and is partly ascribable to human inertia and partly to entrenched vested interests.

The second approach of a central maintenance of accounts is an antithesis of the combined arrangements but represents a halfway house to full decentralization. Under this system, accounts are centrally maintained by an accounts department that is usually located in the Ministry of Finance. It works through a series of outposts attached to different ministries and regions and is responsible for the preaudit, payment, and compilation of government accounts. The structure of accounts adopted and the general controls exercised in all these processes is the same as in combined accounting and audited offices, with the major difference that accounting is located within the executive branch.

The third approach recognizes that the centralized maintenance of accounts is an anathema to the increased competence of financial management in the spending agencies. The premise of this approach is that, if accounting is to serve as a policy instrument, it must be handed over to the agencies. While the broad design and content of the accounting agency would be subject to central approval to ensure observance of the needed financial controls, variations are permitted to reflect the specific requirements of each agency. It is an effort in the direction of making accounts an integral part of administrative management. In some cases, however, payments are made by the central agency through disbursing officers attached to the spending units. The role of the central agency in this set-up is limited to the oversight on the adequacy of accounting systems, to the reconciliation of accounts with monetary agencies, and to the final consolidation of accounts.

Given the imperatives of financial management, it seems appropriate to extend decentralization in accounting responsibilities to be in accord with the distribution of functions in government, to reduce the

29 Such an arrangement is also necessitated by the computerization of accounts.
gap between accounting and policy management, to minimize delays in accounting, and to reduce the inconvenience to the public.

**COMPUTERIZATION OF ACCOUNTS**

The introduction of electronic data processing (EDP) machines has had a significant impact on the accounting systems in industrial and in some developing countries. The process has been further facilitated by the adoption of similar approaches in the banking industry. The main attraction of computer systems is their capability for handling a greater volume of work, quickness in compilation, ready retrieval procedures, and, more recently, lower costs of operation. The systems are particularly useful in maintaining central payrolls, pension payments, grants to state and local governments, and grants or transfers that are administered on a centralized basis. The introduction of EDP systems generally require well-organized payment procedures (whether on a centralized or a decentralized model), standardized bookkeeping practices, and an efficient postal system. Common classification or codification would also be needed as part of these procedures.

The introduction and experience with computer technology reveals different experiences in industrial and in developing countries. While initial teething problems are common to both groups of countries, it appears that improved classification of transactions, decentralization of accounting responsibilities, and modern communication systems have been of great assistance to the industrial countries in realizing the benefits of computerized accounting systems. Annual audit reports in these countries, however, point up what could eventually become a major problem. It appears that no adequate machinery has been developed to detect fraud by the subtle manipulation of accounts and computer software.

The experience of developing countries is more diversified. There are countries that have invested vast sums and computerized their accounting systems. On the whole it seems that their experience with computerized systems has been successful. There are also countries where the introduction of such systems has been followed by considerable problems. In some of these countries, accounting procedures were not streamlined prior to the introduction of the EDP systems and as results proved disappointing some countries quickly reverted to manual procedures. These experiences suggest that...
solutions to procedural and institutional problems illustrated in the earlier sections should be accorded greater priority; clearing the thickets and swamps in accounting systems is a necessity that becomes more urgent in the context of computerization.

**FINANCIAL INFORMATION SYSTEMS**

The basic purposes of government accounting systems and information systems (discussed in the previous chapter) are basically the same, as both are intended to provide policymakers with a quantified view of the extent to which current developments are deviating from the original plans and expectations. There is, however, a major difference between the systems. Appropriation accounts and related reports are designed to meet the requirements of the policy maker, as well as to comply with the constitutional, statutory, and other legal requirements of the country. Information systems have more limited aims and are primarily intended to provide managerial accounts developed in a manner that will permit the effective internal control of funds, program management, and evaluation. Information systems are primarily statistical reports that cover both physical and financial aspects and provide data by type, location of responsibility, and program, and are assessed in relation to specified targets. The data so produced are essentially intended for internal use and often may not be published. Accounting reports, on the other hand, are more formal and are always published. An information system is an offshoot of an accounts system and cannot exist without it. The concern here is with the reports prepared and published by the accounting agencies in government.

Two types of reports (distinguished by periodicity and the extent of detail) are prepared. Although the nomenclature of these reports differs from country to country, the reports are essentially a monthly one and an annual one. The monthly report is a summary of the receipts and outlays and the means of financing the public debt. It seeks to disclose the relevant fiscal transactions of the previous period and is not intended to disclose each and every government transaction. The annual statement represents a detailed and comprehensive list of transactions (classified by type) and presents an analysis of budgetary results and other information relating to a fiscal year. The latter category includes additional data on supplementary appropriations and
their use, contingent liabilities, and nature and type of debt contracted. The annual statement is intended to reflect the stocktaking for the year and thus serves as a window on government to the legislature and the public. For purposes of policy formulation, however, it is obsolete in the sense that fiscal and monetary policies would have already been determined by the use of monthly statements. The usefulness of the annual statements should not be minimized, however, for they serve as the only authentic statement of the budgetary results for the year.

The usefulness of these reports appears to have been reduced in practice owing to structural limitations and technical snags in their preparation. Both these features are common to industrial and developing countries, although they tend to be particularly aggravating in the latter. Ideally, the policy purposes would be well served only when the scope of monthly and annual reports is the same as that covered by policy. As government accounting systems typically follow the same coverage as the budget, they exclude those autonomous agencies and funds. Also excluded are public enterprises because of their separate form and organization. During recent years most fiscal stresses on governments have arisen from the spillover of financial difficulties from autonomous agencies and enterprises and these remain outside the scope of accounting reports, both in the formal (which is to be expected) and in the analytical sense. Central governments are generally responsible for the fiscal policy of the government and the budgetary functions are shared with a multitude of state and local governments. The impact of the operations of the latter on the economy is as important as that of the central government. It is generally true that, in developing countries with federal systems, the compilation of timely accounts of other entities has been difficult and difficulties have been experienced in obtaining an overall view of "government" activities. Even within the limited sphere of the central government, it is observed that information requirements are not homogeneous and the heterogeneity of users may not facilitate the overview needed for economic and financial management. The aggregation of departmental records does not necessarily meet the information requirements of central policymaking. More important is the fact that financial information is presented in such a way that its significance is not self-evident. In many developing countries, monthly reports routinely provide information on receipts, expendi-
ture, and, to some extent, debt, but are not analytically presented to reveal the size (and the changes therein) of surplus or deficit.

The usefulness of the reports depend on the timeliness with which data are submitted. It is a common occurrence, however, that these are frequently delayed. Several factors contribute to this situation. Some arise from the nature of accounting transactions, such as settlement accounts or the large number of bank transcripts, but these are peripheral in relation to the human factors. These include lack of understanding of the importance of accurate and timely reporting and its impact on fiscal policy formulation, disregard for established deadlines, delay in reconciliation efforts, lack of communication between the accounting and the budgeting offices, and lack of understanding of the relationship between monthly reports and year-end reports. In several developing countries, annual accounts reports are published after a lag of about four to five years, and are thus not even of historical interest. To ease this situation a concerted effort is required to solve the structural, technical, and human problems, as this involves considerable effort and extra costs, it appears more a job for long distance runners than for sprinters.

**Balance Sheet for Government**

Suggestions have been made in recent years about the need for the compilation of an annual balance sheet for the government as a whole. This balance sheet differs from those that are routinely attached as a part of the annual appropriation accounts in the British Common-wealth system and is intended to provide a “bottom line”—an indication of the performance of the organization. The approach is inspired by the lengthy experience of the commercial world and the objective is to assist the average citizen (the counterpart of the investor) or financial expert to judge the effectiveness of past spending decisions and to ascertain the government’s ability to raise revenues and acquire the resources necessary for future years. A beginning was made in this direction by constructing prototypes of accounts of the Government of United States.

30 For an interesting account of the factors contributing to delays in the United States, see James J. Lucas (1979), pp. 8–18.

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The balance sheets prepared in the United States\(^{31}\) include details of assets and liabilities of the federal governments and are compiled by using a wide variety of sources. The assets include cash and monetary assets, receivables, inventories (including military stockpiles), and the value of property and equipment less accumulated depreciation. The liabilities comprise federal debt, payables, retirement and other benefits, and accrued social security. The coverage of the balance sheets, as well as the proposed treatment of some items, lends itself to debate and disagreement. For example, assets do not distinguish between public and financial sectors and the assets and liabilities of the central banking system are included. Land and buildings owned by government are included and, in a clear departure from the national accounting precepts and practices, military properties are also included. Liabilities exclude guaranteed liabilities and depreciation is envisaged as being calculated on a straight-line method and on the assumption of an average life span of 50 years for government buildings.

The debate centers around both the treatment and the need for such balance sheets. The issues that have not been satisfactorily resolved relate to the determination of the market value of assets, the treatment of defense, and the rate of depreciation. Equally significant is the issue of how for purposes of policy formulation, the balance sheet is superior. It could be argued that the relevant information needed by the average citizen is available in the budget documents, annual accounts, and assorted analytical tables. The balance sheet does not appear to have any additional use for program management or for the maintenance of accounts. To the extent that the balance sheet is perceived as back-door attempts to bring accrual systems, it appears that the purpose could be better served by less controversial devices.

Part Three

BUDGETARY RELATIONSHIPS
Public enterprises and autonomous agencies have grown in size and scope during recent years. Their working reveals many problems common to both industrial and developing countries. It appears that public enterprises have added to the budgetary pressures by shifting some burdens to the government budget, thus endangering its already fragile balance. Government's role as a model employer appears to have contributed, in several instances, to a general wage push in the economy. The sick units taken over by government have become, in many cases, permanent activities of government. Instead of contributing to additional resource mobilization, enterprises have become more dependent on the government budget. Instead of fulfilling development tasks, they have contributed to delays, inappropriate investment choices, capital intensive technology, cost escalation, credit expansion, prevention of credit to other needy sectors, and, overall, to an inefficient allocation of resources. The autonomous agencies have also grown in some countries and have by their existence diminished the importance of government budget and reduced the amount of legislative control. Both these areas represent significant segments of the total activity of the public sector, and the financial issues relating to the operations of both make systematic analysis a compelling necessity. The relationships between government and enterprises have hitherto been examined in the literature in terms of provision of finances, forms of enterprises and the formal controls exercised in the process of release of funds, and utilization of funds by enterprises. But
the structural budgetary relationships between government and enterprises, in particular, the type of financial controls exercised, have not been given due consideration. The autonomous agencies and their issues have received much less attention. This chapter considers the nature of these organizations, their budgetary relationships, and the broad ranges of issues in the policy and institutional areas.

PUBLIC ENTERPRISES AND AUTONOMOUS AGENCIES DISTINGUISHED

Public enterprises do not lend themselves to precise definition, as illustrated by the many attempts made during the last two decades.\(^1\) In one of these attempts, Hanson offered more of a description than a definition when he stated that they primarily relate to “industrial, agricultural, and commercial concerns which are owned and controlled by government . . . where the state 'participates' in mixed enterprises, the criterion employed is that of control. If the state contributes more than 50 percent of the capital of a mixed enterprise, it automatically has a controlling interest. It may actually exercise control even when it holds a small proportion of the shares. In either case, the enterprise is included in the 'public' category.”\(^2\) The System of National Accounts (SNA), added an additional criterion relating to their activities and defined enterprises as organizations that are “entirely, or mainly, owned and/or controlled by the public authorities consisting of establishments which by virtue of their kind of activities, technology and mode of operation are classed as industries.”\(^3\) Elsewhere, the System added the criterion of marketability and included in public enterprises those “large incorporated units (government enterprises) that sell most of the goods or nonfinancial services they produce to the public.”

The operational aspects of the definition of ownership, control, and marketability are, however, ambiguous, lead to practical problems,

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\(^1\)This has contributed to some problems in identifying government enterprises. In Canada, for example, it was hard to determine how many crown corporations have been established by various governments, let alone their importance or whether their number has changed over time. In fact, there has been no clear picture of the extent of government business activities in Canada in the postwar period. See Richard M. Bird (1979), p. 3.

\(^2\)A. Hanson (1968), p. 6.

and do not in any event permit a meaningful international comparability, which is one of the aims of the National Accounts System. The ownership criterion has been limited in this approach to enterprises in which "all, or a majority, of the shares of, other forms of capital participation in, or the equity of the unit" are owned by public authority. In practice, this could eliminate some of the enterprises where a minority share is held by government but the enterprise is basically controlled by it. In partial modification of this definition, Leroy Jones suggests that "[a] public enterprise is a productive entity which is owned and/or controlled by a public authority and which is autonomous and/or produces a marketable output."\(^4\) Ownership for the purpose is defined as being where more than 10 percent of the equity is held by the public authority and output is considered as marketed where at least half of the current costs are covered. The application of this approach does not reduce the problems faced in the SNA definition and gives rise to a number of borderline examples. There may be several enterprises where government capital may be limited but its control is extensive for purposes of "goal realization."\(^5\)

Many countries in West Africa and Asia have enterprises that, in view of their strategic role, are totally controlled by government but are organized as "mixed companies" (joint ventures) with only minority shareholdings. Similarly, the application of the criterion of 50 percent recovery of costs for proving marketability would mean the elimination of enterprises engaged in the provision of infrastructure services or in the fulfillment of other national objectives, or those that have "long periods of initiation" and therefore cannot recover costs in the early stages of operation. An associated criterion is the addition of a value-added measure, but the application of this would result in the elimination of trading enterprises owned by government. Each definition thus appears to have one limitation or another and cannot encompass the variety of enterprises and local practices. For purposes of analysis, however, the reference here is to nonfinancial public enterprises (NPEs) that (a) are engaged in the production and sale of goods and nonfinancial services and (b) keep separate budgets and accounts. These may be organized in any form. From the budgetary


\(^5\)In a case study of enterprises in Nepal, the above type of public enterprises were called "quasi public enterprises." See Nepal (1977).
angle, these primarily consist of organizations that are owned and controlled by government, that have received their initial investments from government, that are under the administrative control of a sponsoring ministry, that generally have access to government budget, and that are used as instruments of government policies within the macroeconomic framework. Financial institutions, which primarily work as deposit accepting and credit providing institutions, are not included in this category for the reason that, although they are owned and controlled by governments, their operations come within the ambit of monetary policy. Also excluded are defense-oriented industries and other institutions organized to provide specific social services such as education and medical services.

Autonomous agencies, which are also known as decentralized entities, have not been defined in the same formal way as enterprises. But their nature is revealed by the common spectrum of experiences and, for analytical purposes, the reference here is to organizations that are set up by government with a specified degree of functional autonomy to provide a service to the public or to undertake a promotional or developmental activity. These agencies may be engaged in the production and sale of services, but their primary purpose is not so much commercial as to provide a service. NPEs may often have operational revenues that are earned mainly by the sale of goods and services. Autonomous agencies to which the commercial motive is secondary are dependent to a large extent on government transfers, earmarked revenues, or related sources of revenue. The activities of autonomous agencies are generally the traditional concerns of government and would normally be undertaken by it but for their separate organizational status. Enterprise activities, however, represent an extension of government into business. The difference between the two is not merely one of financial dependence on government but of purpose and character of activities. The service motive or the administrative agency function of government dominates the autonomous agencies. Enterprises are, in theory, primarily commercially oriented, they charge a price that is expected to be determined by market forces, and they have the authority to borrow both domestically and from abroad either on their own credit or through government-guaranteed loans. For autonomous agencies fees are charged to recover a part of their cost. Prices of enterprise products may also be
established to yield higher returns and may at times be used as substitutes for taxation. No such role is generally assigned to autonomous agencies, nor do they have powers to borrow on their own either from the domestic banking system or from the market. Frequently, however, these distinctions are not observed and in practice some commercial activities may be undertaken by those that are shown as autonomous agencies and, conversely, some organizations shown as enterprises may be pursuing noncommercial activities. These distinctions are, however, important for they have a substantial influence on the nature of budgetary relationships, controls exercised in the financial process, and the evolution of appropriate evaluation criteria.

**Nonfinancial Public Enterprises: Evolution, Growth, and Objectives**

Nonfinancial public enterprises (NPEs) represent a significant aspect of state activity. Their growth reflects a change in the philosophy of the state. From what was considered to be limited supervisory functions such as law and order, the role of the state has expanded into industrial, manufacturing, and commercial activities, in addition to its regulatory role. This change has been contributed to by ideological, sociopolitical, and situational and practical factors. Among the ideological factors is the growth of socialist thought and the shift of production from private to public ownership that it
implies. In developing countries, this was accompanied by the prevalence of a national sentiment that viewed some private enterprises as successors of former colonial governments. The distrust these countries had for such firms led to greater participation by the state in production activity. From the social and political point of view, the lack of skills within the private sector⁹ and a recognition that that sector could not be relied upon either to create the required employment or to provide opportunities for education and training have also contributed to greater participation by the state. In some countries, interests emerging from the political and economic survival have contributed to a greater role for state enterprises. The nationalization of foreign-owned private companies in the wake of independence belongs in this category. In numerous other cases, it was a combination of practical and situational factors that contributed to the spread of state ownership. After World War II, enterprises were used for the reconstruction of the economy and as tools for fighting recessions. The countercyclical role envisaged for enterprises was based on the belief that action through market mechanism was not adequate, as “pushing the string” had its limitations, and that more active and direct participation in the economy was essential. The growing emergence of sick industries in the private sector, together with the desire to maintain output and employment, has often forced governments to acquire enterprises. Once acquired, however, enterprises tend to develop their own durability. There were also deliberate plans for acquiring ownership, which, in turn, was influenced by the following factors: (a) a desire to compensate for the private investment in sectors where it tended to be shy either because of high taxation of profits, capital scarcity, or the high risks involved; (b) defense considerations and strategic needs necessitated direct government ownership in some sectors; (c) a recognition that state participation could promote development in backward regions, in areas where infrastructure services were needed, or in areas where major foreign investment was needed; and (d) consideration that acquisition of profitable activities could make a more substantial contribution to the national resource

⁹In Turkey, the Government adopted a policy of statism during 1923–32 because of a shortage of skills within the private sector, although it was recognized that the dominant role should be played by private initiative and capital. See James W. Land (1971).
mobilization efforts. Acquisition of export businesses and management of traditional fiscal monopolies were partly motivated by this factor.

The more recent growth in the state enterprise sector can, in part, be ascribed to the tendency of state-owned enterprises to acquire subsidiaries because of their product relationships or, in some cases, simply because of the need for diversification or because of the availability of an investment opportunity. Also, government-owned financial institutions have started owning and investing in new promotional ventures. Examples of this are to be found in almost all countries, particularly in India, Italy, Korea, Spain, and the United Kingdom. The state sector now covers a vast area of economic activity and its functions range from agricultural farms to highly sophisticated and high-risk ventures such as aerospace industries and include the manufacturing of capital and consumer goods, mining and extractive activities, and trading and marketing. In many countries, strategic sectors such as energy, transportation, communications, and iron, steel, and coal production are completely operated by state enterprises. Since 1938 there has been a gradual extension of the state sector to the exploration, refining, and marketing of oil products and the share of state-owned oil companies in 1975 was more than 60 percent of total production. Yet another sector where growth in developing countries had been sizable was in the establishment of marketing boards. Although these boards are to be treated, in terms of the above-mentioned criteria, as autonomous agencies when their role is regulatory or advisory, some of them have a monopoly on importing or exporting, on domestic trading and are responsible for price stabilization for producers and consumers and are, therefore, a part of enterprises. The growth of traditional activities in the sphere of public utilities to a wider sphere implies that, with advancement at each stage of industrialization and trade, government enterprises tend to become more prominent in national economic decision making. But the increasing importance of NPEs in economic management does not necessarily imply that economies dominated by state enterprises are equivalent to centrally planned economies. It is generally true that the successful operation of public enterprises leads to the growth of auxiliary industries and results in generally increased investment opportunities for the private sector. In a centrally planned economy, more emphasis is laid on physical allocations and administered prices, while in economies that are dominated by state enterprises, reliance
continues to be placed on the market system.\textsuperscript{10} Other distinguishing features are to be found, apart from ideology, in the degree of ownership, extent of operation, and severity of controls.

The wide network of enterprises has been classified in a variety of ways. For example, these enterprises are classified by legal form—corporations, companies, boards; in terms of branches of operations such as those manufacturing capital goods or consumer goods; in terms of motives—provision of merit goods, ownership of natural monopoly, prevention of noncompetitive practices; in terms of roles—promotional, supplementary, and replacement; and in terms of size—location, forms of production processes, rate of return, and related features. For purposes of examining the budgetary relationships, however, it is more appropriate that these enterprises be divided into distinct and meaningful cognate groups that indicate the economic environment in which they function, the broad tasks expected to be performed by them, and their budgetary relationships. Broadly, these groups comprise public utilities and manufacturing, capital and consumer goods, mining and extractive industries, trading and marketing, and other quasi-commercial services. The relative roles of these enterprises may change in the context of the objectives of government.

The growth of enterprises essentially reflects the wide variety of objectives that governments have for them. Among others, these objectives include eradication of poverty, attainment of self-reliance, egalitarian distribution of income, promotion of employment, balanced regional development, and prevention of concentration of economic power. An ever-present objective of public enterprises is to ensure an efficient allocation of resources. Government ownership may not by itself guarantee or even promote efficient resource allocation. A certain degree of market behavior, in particular the acceptance of opportunity cost pricing, may be needed on the part of enterprises if this objective is to be achieved. Social and distributional objectives are common for public enterprises and have, in fact, contributed to the expansion of public ownership. In developing countries, the objective

\textsuperscript{10}The distinctions between centrally planned economies and others tend to be fuzzy in practice. The movements of laissez-faire and collective ownership have, over the years, led to liberal-social democratic solutions and increasingly countries that hitherto stressed collective ownership are moving to "market socialism." For an interesting discussion of these aspects, see Assar Lindbeck (1977).
of growth is also important and public enterprises are assigned key roles in the development plans. Both growth and distributional objectives are pursued by massive investments in the expansion of enterprises and by implicit taxes or subsidies in the prices of enterprise outputs. Charging a price that is less than the social cost of the resources used in production, for certain goods and services (and depending on the price and income elasticities of demand), may be a more effective method of shifting real income than direct budget expenditures. However, some subsidies may have the disadvantage of not discriminating against the groups of beneficiaries and the total costs of subsidization may be obscured. Stabilization objectives of government are achieved both by selective enterprise-oriented measures and the aggregate impact of NPEs on government budget. The main difference in the growth of enterprises in industrial and developing countries is that enterprises were used by the former to salvage the uncompetitive concerns that at the end of World War II and since then were left with undercapitalization and insufficient modernization. During the 1960s and 1970s, however, there was a shift of emphasis, and policies of price restraint for the enterprise products were adopted in the hope that such policies would check the acceleration of inflationary pressures. In the developing countries enterprises were used during the early 1950s and 1960s as instruments more of development, although marketing boards continued to play a major role in stabilization by protecting the producer (by guaranteed prices) from short-term external fluctuations. During periods of recession, selective expansion is undertaken by governments in public utilities and other enterprises. But their major policy instrument is the takeover of sick units when massive unemployment is threatened or similar disruptions are expected. During periods of inflation, the instruments available to government are price restraint on enterprise products, investment deferral, reduced provision of capital, and greater emphasis on self-financing. Where deficits of enterprises are contributing to higher government budget deficits, selective measures of price revision, cost reduction, reduced subsidies, and limits on domestic and external borrowing are observed.

The above-stated objectives are not always reconcilable and, indeed, it is a moot point whether deliberate efforts are made to reconcile them. In general, however, most NPEs are also expected to pursue noncommercial objectives. Given the multiplicity of goals, the
question for consideration is whether in this regard there is a single paradigm governing the approaches of public authorities. It is argued that NPEs should be commercially oriented and, like any other private sector counterpart, should aim at profitability. The pursuit of this maxim implies that enterprises should operate efficiently and maximize their profits—an aspect that is to be related to other responsibilities that devolve on enterprises as instruments of government policy. It seems to be the general expectation that public enterprises work as model employers and respond to public demands in a more positive way while protecting the interests of their investors (society itself) and their consumers. The conversion of these goals into day-to-day management and their reconciliation with the profit goal has never been an easy one. Indeed, these goals remain the unresolved dilemmas of the society.

The role and guiding spirit of enterprises have been viewed differently at various stages of development. In industrial countries during the early years of nationalization after World War II, the policy approach was that enterprises should aim at recovering their total costs. In practice this meant the adoption of a no-profit, no-loss approach. This, in due course, yielded to an approach that emphasized commercial profitability. Later, the concept of profitability was developed further and the new aim for NPEs was that they should obtain profits that reflected the opportunity costs of capital. These considerations, together with the role of NPEs in stabilization, development programs, and as fiscal agents for raising revenues or as instruments for subsidization, form the desiderata for an evaluation of government budgetary processes.

AUTONOMOUS AGENCIES: NATURE AND STATUS

Over the years two considerations have led to the increase of autonomous agencies. First, there was a feeling that government

\[11\] In 1969 a seminar of experts conducted by the United Nations reported that "the sentiment of supervisory authorities is increasingly more favorably disposed to the commercial profitability criterion. . . . The shift away from the practice of 'no profit, no loss' in the British nationalized industries together with the renewed emphasis on profit in the recent Soviet reform program have reinforced this trend of official
departments that have no function within the formal structures and regulations of government might not be best suited to performing certain tasks, particularly those having considerable contact with the public. The financial discipline in the government might contribute to delays and associated problems and it was hoped that these could be minimized if agencies were separated from the discipline inherent in the government budget. Second, in some countries where the approval of budget appropriations by the legislature tended to be delayed and where the legislative overview was considered more of a hindrance by the executive than an exercise of legitimate function, efforts were made to separate portions of the budget and preserve them in the constitution with their own revenues. There was also a feeling (that does not lend itself to empirical verification) that the budget deficits could be managed within specified limits by a process of limiting the scope of the budget by setting apart some activities. Parts of the budget so separated were financed by borrowing and, being independent, were not reflected in the computation of government budget deficit. The systems in which these autonomous agencies prevail may be divided into limited (less than 20 in number), intermediate (20 to 50), and extensive (more than 50). Table 25 shows data for 31 industrial and developing countries and the number of agencies operating in each. It shows that the highest number of autonomous agencies are to be found in Europe, Latin America, and some British Commonwealth countries. Most of these agencies are educational (generally universities) and medical institutions, and several regulatory and promotional organizations. Their revenues are derived from budget transfers and are complemented by other receipts—primarily fees—drawn from the sale of services or regulatory functions.

The role assigned to the autonomous agencies is broadly the same as those of spending agencies. To that extent, the emphasis on allocative efficiency, stabilization, and distributional goals, and concerns of growth apply equally to the autonomous agencies. The approaches adopted toward their budget making are also the same as those of the spending departments. The primary differences between autonomous thinking. The profitability criterion, it seems, has now become the official doctrine.” This did not, however, specify the level or the measurement of profit. See United Nations, Improving Profit Performance of Public Enterprises in Developing Countries (1969), p. 29. 

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Table 25. Autonomous Agencies in Government

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limited Systems</strong></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>19</td>
</tr>
<tr>
<td>Cyprus</td>
<td>3</td>
</tr>
<tr>
<td>Germany, Fed. Rep. of</td>
<td>1</td>
</tr>
<tr>
<td>Haiti</td>
<td>5</td>
</tr>
<tr>
<td>Jordan</td>
<td>7</td>
</tr>
<tr>
<td>Kuwait</td>
<td>5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>12</td>
</tr>
<tr>
<td>Mauritius</td>
<td>10</td>
</tr>
<tr>
<td>Netherlands</td>
<td>16</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>10</td>
</tr>
<tr>
<td><strong>Intermediate Systems</strong></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>33</td>
</tr>
<tr>
<td>Canada</td>
<td>22</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>40</td>
</tr>
<tr>
<td>Morocco</td>
<td>39</td>
</tr>
<tr>
<td>Singapore</td>
<td>23</td>
</tr>
<tr>
<td>Tunisia</td>
<td>35</td>
</tr>
<tr>
<td><strong>Extensive Systems</strong></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>182</td>
</tr>
<tr>
<td>Belgium</td>
<td>107</td>
</tr>
<tr>
<td>Bolivia</td>
<td>57</td>
</tr>
<tr>
<td>Brazil</td>
<td>206</td>
</tr>
<tr>
<td>Colombia</td>
<td>74</td>
</tr>
<tr>
<td>Denmark</td>
<td>800^2</td>
</tr>
<tr>
<td>Egypt</td>
<td>53</td>
</tr>
<tr>
<td>France</td>
<td>109</td>
</tr>
<tr>
<td>Iran, Islamic Rep. of</td>
<td>120</td>
</tr>
<tr>
<td>Jamaica</td>
<td>91</td>
</tr>
<tr>
<td>Peru</td>
<td>150</td>
</tr>
<tr>
<td>Portugal</td>
<td>247</td>
</tr>
<tr>
<td>South Africa</td>
<td>76</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>60</td>
</tr>
<tr>
<td>Venezuela</td>
<td>53</td>
</tr>
</tbody>
</table>

Source: Compiled from country notes in International Monetary Fund, Government Finance Statistics Yearbook, 1980, Vol. 4 (Washington, D.C., 1980).^1^ Data restricted to central governments only, excludes social security agencies. Number refers to those agencies that have their own budgets.

^2^ Approximately; refers to government agencies (quasi-statslige institutioner).

agencies and enterprises are in the source of funding and in the exercise of controls. As budget-making aspects of spending departments were considered earlier, the following discussion focuses on NPEs only.

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BUDGETARY RELATIONSHIPS: ENTERPRISES

The growth of NPEs has contributed to a change in the character of government budgeting. The concerns of the government budget were traditionally regarding the allocation of resources to functions such as administrative, social, and economic services, but now they relate to a host of issues, including financing enterprises, appraising of investment and pricing policies, and the rate of return. Governments now routinely review the budgets of enterprises for two reasons: first, to determine the role of enterprises in the allocative, distributional, and stabilizational aspects of the management of the national economy; and second, in a narrower sense, to determine the resources to be transferred to enterprises. These reviews, in turn, are based on reviewing the validity of the estimates of production, sales, and related finances. These concerns may have appeared remote not so long ago but have now become an accepted part of the budgeteer's lexicon.

Government is both the major shareholder of and, in many countries, the principal banker for enterprises. Budget is the main link that provides a continuing relationship with the NPEs throughout various stages of policy formulation and execution. Public enterprises are distinguished from others, mainly in terms of the financial significance inherent in their permanent relationship with government. The permanent relationship has two important features. First, because the government provides all the money either from its budget or from its financial institutions, there is, in general, little

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12 Transfers from government budget to NPEs take a variety of forms and there are formidable difficulties in providing data on a comparable basis for the quantitative aspects of the relationships. Some conclusions can, however, be drawn from the examples of India and Korea. In India the annual government investment from the budget in its NPEs was more than a fourth of total government capital expenditure during 1975/76–1978/79. As a proportion of total expenditure, it was more than 10 percent. During the fourth plan period (1969–74), about 8 percent of the total plan resources was contributed by all government enterprises. Subsidies provided by the central government were on average 6 percent of total expenditures during the late 1970s. In Korea the annual government investment in its NPEs during 1975 and 1976 was about a fourth of its development expenditure, which declined to about 9 percent in 1979. As a share of total government expenditure, it was 12 percent in 1975 but declined to 3 percent in 1979. Similar magnitudes are observed in many industrial and developing countries.

13 In some countries, operational funds are obtained from the commercial banking system.
The likelihood of a threat of liquidation of enterprises. Although this is not universally correct, it has contributed to the perception that the financial problems of enterprises, in due course, become the problems of the government budget. This imposes an additional responsibility on the government budget not merely to invest or approve specific expenditure proposals but to anticipate the problems of enterprises and the impact of their operations on the government budget. Such anticipation in turn generates some institutional and procedural imperatives that are reflected in the budgetary process. Second, from the enterprise point of view, the parameters of its budget other than sales revenue, are exogenously determined by the constraints characterizing the government budget. Income policies, resource mobilization measures, perceived rate of growth of expenditure, or the ratio of budget deficit to GDP all tend to influence the transfers to and from the government budget. These factors are viewed, albeit legitimately, as constraints that would not be felt if enterprises were left to their own devices. This approach has, however, some limitations. The enterprises that are dependent on government cannot, by their very nature, be able to generate their own resources to the required degree. There may, however, be some enterprises, such as manufacturing industries functioning in an open competitive environment that may be self-reliant, which anyway may be independent of some part of the fiscal discipline that stems from the government budget. State ownership implies certain social and economic responsibilities and these cannot be entirely ignored in considering the financial requirements of enterprises. If it is argued that enterprises are to be insulated from the macroeconomic responsibilities of government, then the onus of adjustment, when required, will shift to the rest of the public sector. A plausible case, however, can be made for certain enterprises (for example, public utilities) to be exempted from the macroeconomic functions but efficiency considerations of management require that such enterprises be specified in advance. It may also be noted that the "freedom approach" may not be tenable in countries where banking institutions are either owned by government or often function in close harmony with the budget and a joint determination is made for the fiscal resources to be made available to enterprises (e.g., in Korea). Moreover, in pursuing a stabilization program, credit limitations apply equally to all enterprises and the NPEs may not fare differently in obtaining loanable funds. Specifically, in developing countries, the
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public sector, which plays a dominant role in the economy, may have to bear the major brunt of adjustment needed for stabilization and this, in turn, affects the budgetary prospects of enterprises. The intimate relationship and the complementarity between a government and enterprises leads to a policy framework in which there is little option for NPEs but to work in tandem with government.

STRUCTURAL ASPECTS

Budgetary relationships between government and enterprises are dependent on the form and nature of the organization of the latter and to what extent government budgets may not fully reflect the activities of enterprises. Broadly, however, three types of institutional practices can be distinguished. The typology is not rigid and there may be cases that have all the following features in varying degrees.

First, there are systems where enterprise budgets are included in the government budget or where the dividing line between the two budgets is thin. Enterprise activities that are organized on a departmental basis or those whose budgets are annexed to the government budget belong to this category. In countries that follow the French tradition of limite de caisse, public enterprise budgets are subsumed in the national budget and transactions of enterprises are carried out through a special account established in the Treasury and are managed by it on behalf of enterprises. Another variant of this broad approach is the practice prevalent in some countries, such as the United Kingdom and the Federal Republic of Germany, under which financial requirements of the enterprises are included in the medium-term expenditure plans of the government. In countries with economies that are dominated by public ownership of production activities the enterprise budgets, while not formally included in the central budget, are considered in close conjunction with the government budget and are subjected to the same review as those of departmental budgets. Formal administrative procedures may differ among countries, but these relationships imply a greater degree of integration between government and enterprise budgets.

Second, enterprise budgets in some countries are formulated under the direction of the government but are not included in the government budget. This relationship may be described as directional. This is different from the centrally planned economies in that the scope
of direction is rather narrow. In countries that have formal development plans, capital outlays of enterprises and their pattern of financing are reviewed as integral parts of the plan. In countries that have no plans, enterprise budgets may still be considered and approved by the ministries of finance.

Third, there are some countries where enterprises formulate their own budgets and are subjected to government review only in regard to specific aspects, such as capital expenditure or subsidies given for specific purposes. This type of relationship is less formal and enterprises are generally endowed with a greater degree of autonomy. In some of these cases, capital transfers from government may not fully reflect the capital budgets of the enterprises, for there are other sources of financing. In some countries, project loans received from abroad may be on-lent to the enterprises through government budget, while in other countries, loans may be received by enterprises on the basis of government guarantees.

The form of budgetary relationship is also influenced by the structure of enterprise budgets. The enterprise budgets are organized on a dual basis, viz., revenue and capital. The revenue budget consists of the sales and income budget, production, research, and development budgets, selling expenses, and administrative overheads. The capital budget consists of the proposed outlays on plant, machinery, and buildings. Supplementing these two, a cash budget showing the flows of receipts and outlays is also prepared. The transactions between government budget and enterprise budget, however, receive asymmetrical treatment in that an expenditure item in the former will be a source of revenue to the latter. The broad spectrum of budgetary relationships are illustrated in Chart 8. These procedures, however, have some limitations. In departmental enterprises whose budgets follow the conventional budget structures of government, estimates of receipts and outlays are not formulated in the commercial format. In some countries, for example, Sudan, even the commercial public enterprises may prepare their budgets in terms of the government budget chapters, viz., salaries, capital equipment. The budgetary structures of enterprises, unlike those of government, do not appear to have received serious consideration and are generally assumed to be adequate as they conform to commercial formats. The links of public enterprises with government are, however, such that some modifications appear appropriate for a variety of reasons. First, strategic or
Chart 8. Budgeting Relationships Between Government and Public Enterprises

Government

Receipts
- Taxes
- Interest on loans
- Dividends on investments
- Repayment of loans
- Transfers of surpluses from public enterprises

Expenditures
- Transfers from earmarked revenues
- Subsidies
- Property income
- Less: Production costs
- Adm. expenses
- Debt service
- Investment in equity
- Short-term and long-term loans

Public Enterprises

Operational account
- Sales revenue
- Transfers from earmarked revenues
- Subsidies
- Interest
- Depreciation
- Profits before tax or losses
- Less: Taxes paid
- Profits after tax
- Less: Dividends and surpluses transferred to government
- Profits retained
- Capital account
- Receipts
- Share capital
- Reserves and surpluses
- Borrowings
- Other inclusions
- Outlays
- Acquisition of assets
- Borrowings
- Other

Long-term loans
- Short-term and long-term loans
corporate planning and budgeting appear to follow two different paths, the former emphasizing product development and diversification and the latter tending to be a purely financial exercise. A integration of these two aspects is, however, essential to serve the internal management as well as for rendering greater accountability to government at the prebudget scrutiny stage. Recognition of this aspect induced some governments to adopt a type of performance budgeting for public enterprises. A continuing experiment undertaken in this respect in India shows that performance budgets vary widely in quality and have tended to become perfunctory routines rather than significant inputs into the decision making of government or enterprise management. Second, as the overall nonfinancial public sector is the key factor in national economic management and as national income accounts and related forecasts are used as the basis for policymaking, it seems essential that enterprise budgets are improved to facilitate quick compilation of national accounts. Some countries, notably France, have evolved general accounting plans that would meet the requirements of enterprises while serving the needs of national accounts. Elsewhere, however, experience suggests that difficulties are experienced primarily because enterprise budgets are structured to meet different purposes and their balance sheets do not provide the detail needed by national accounts.

**BUDGETARY PROCESS**

The budgets of public enterprises are prepared within the time dimensions and the processes specified by government. Operational procedures vary from country to country. Generally, however, public enterprises draw up their budgets first, and after these are approved by the boards of directors they are sent to the sponsoring ministries.

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14 This problem may not arise in some traditional public utilities (e.g., electricity) that have only one product and, as such, physical and financial planning go together.

15 During recent years, considerable emphasis has been laid on the formulation of corporate plans in both industrial and developing countries. These plans are generally required to be reviewed and approved by the government.

16 In India, the Administrative Reforms Commission (1966) first suggested the introduction of a comprehensive budget to compensate for the shortcomings of the commercial type of budgets. For a critique of this approach, see A. Premchand (1969a), pp. M13–17.
which, in turn, process them for approval by the central agencies. In some countries only capital budgets of enterprises need to be submitted, while in some others both revenue and capital budgets have to be submitted to government. In countries with large holding companies (Spain, Italy, Korea) or sector corporations (Bangladesh, Pakistan) a major role is played by intermediate enterprises in coordinating the budgets of their subsidiaries. In some cases, the budgets of subsidiaries are also submitted to government, but it is largely an area where much is dependent on the specific situation and initiative of government. The relationships between the sponsoring ministry and finance and planning agencies also differ from one country to another. In Portugal budgets are approved by the sponsoring ministry and only the relevant transfers on current account are shown to the Finance Ministry, while the capital budget and its relevance to the plan are reviewed by the Planning Department. In Tanzania only projects involving transfer of funds from government are considered by the central agencies, while in India the Financial Adviser (who works for the sponsoring and finance ministries and who also functions as a director on the enterprise board) is associated at every stage of budget making from inception to eventual acceptance by government.

The approaches to decision making reveal some departures from the traditions of budgeting. The allocative problem for enterprises is viewed differently from the problem of resource allocation to other services or public goods. Unlike public goods, where the evaluation of costs and benefits is difficult and resort has to be made to imputations, allocations to enterprises involve a more tangible terrain in which the likely rate of return can be identified with some precision. This is not to suggest, however, that no difficulties are experienced in applying the techniques to enterprises. There is, admittedly, a general recognition and acceptance of the shortage of capital and an appraisal is undertaken to reflect an implicit capital rationing. In industrial countries the project appraisal reflects a greater range of technological choices and their relative merits, while in developing countries it tends to be mostly feasibility study of a design that had already been chosen.

The review of enterprise budgets is influenced in part by the typology of enterprises and in part by their financial status. Public utilities, trading and marketing organizations (particularly those responsible for the procurement and distribution of essential food
items), and mineral and extractive enterprises are given detailed consideration, while industrial and manufacturing units receive less. This approach reflects the belief that utilities and trading organizations are more dependent on the government budget (or the government budget is dependent on the enterprise as, for example, in Saudi Arabia and Zambia) for subsidies and price support measures. It is also the general experience that enterprises with deficits receive more attention than others, even if the latter are not making profits. The process within governments reveals numerous weaknesses in dealing with enterprise finances. While the degree of their actual incidence varies from country to country, the following observations are based on experiences that allow generalizations to be made.

First, although enterprises have become a major element in the government's economic strategy in the budgetary process, little or no advance indication is given to them about the possible availability of funds. The estimates indicated in the plans are generally overtaken by events and the annual availability of resources may be considerably different from those stated in the plans. Budgeting has, therefore, tended to become a process of aggregation rather than an iterative one, with interface of central guidance on overall resource constraints, on the one hand, and enterprise requirements on the other. Enterprises formulate their budgets on a need-based approach and governments often work on a resource-based approach. As the initial resource availability is either unclear or is not given due importance, the review within government tends to be ad hoc and resort is made at a later stage to across-the-board cuts in allocations when actual resources are less than estimated. Adjustment to the reduced allocations within enterprises is often not possible within the time allotted and the fiscal year starts with a budget that is far from being synchronized with reality.

Second, government guidance, where provided, has seldom been adjusted for inflation. Apart from the fact that this approach has contributed to investment deferrals or cutbacks, it also has the significant implication that the impact of inflation on the enterprise performance and its feedback to government is not properly recognized.

Third, the nature of financial control exercised by government is tactical and its outlook is narrow rather than being systematic and objective for the whole operation. In the circumstances financial
control tends to be arbitrary and the wider linkages between the enterprises, the government, and the national economy are neglected. The areas given special attention and the degrees of emphasis vary widely among countries. In India attention is on resource mobilization; in the United Kingdom and Korea it is on external financing and the limits on borrowing. Thus, budgetary allocations tend to develop their own bases and narrow rationality rather than concern with the overall role and performance of enterprises.

Fourth, part of the problems experienced in the budgetary process can be laid at the door of the enterprises as well. For their part, they continue to rely on conventional approaches, which reveal undue optimism in their corporate plans and faith in their estimates. They tend to argue in conflicting directions—that their requirements are not substantial, that variations in their estimates are well within the margin of error of government estimates, or, alternatively, stress the strategic nature of their requirements. Recognizing the total dependence on the exogenous variable of government resources, enterprises believe that the place assigned for them in development plans will insulate against short-term changes.

The combined working of the approaches of government and enterprises has, in the process, contributed to a situation where instability has become a characteristic of both levels. In some countries, the converse of the above process works, as additional outlays are routinely proposed for enterprises in pursuit of growth policies but, in the absence of a review of the previous experience, such outlays impose additional strains on the financial management capabilities of enterprises. Yet another commonly observed fact is that budget review pursues the current favorite themes such as prices, financial requirements, and little or no attention is paid, except when losses are severe, to x-efficiency factors such as organizational slack manifested in different ways.17

Difficulties are also experienced on the institutional front. Very few countries have facilities for the systematic collection of annual data on the performance of enterprises and frequent delays in the preparation of balance sheets tend to impede budget review. In some countries, the NPEs have grown so rapidly and become so large that the ability of a central agency or its staff to judge the quality and practicability of

thousands of plans covering complex areas is severely limited in terms of knowledge of local environment, administrative efficiency, or the economics of specific proposals. Moderate advances have been made in organizing central bureaus to specifically look into the enterprise budgets, as, for example, in Mexico. The coverage of these bureaus is, however, limited to major enterprises. Another factor that merits recognition is the lack of clearly delineated responsibilities of the sponsoring ministries and those of the central agencies in the government. Viewed from the enterprise side, it appears that there is no single corporate presence in government and that enterprises are frequently caught in the crossfire.  

**BUDGETARY ISSUES**

The receipt side of the government budget includes taxes paid, interest payments, repayment of loans, dividends on equity, and other contributions by enterprises. The expenditure side of the budget is more complex and the transactions are numerous and include grants or subsidies, investment in equity, loans on-lent, and short-term advances by government. Although provided under different accounting “heads” in the budget, the sum total of these facts reflect the concerns, priorities, and strategies of government. These are further supplemented by the arrangements in regard to borrowing from internal and external sources. The use of these instruments and the determination of the amounts to be given or received have, over the years, given rise to many issues, some of which are considered here from the point of view of the budgetary process.

**TRANSFERS TO GOVERNMENT**

The magnitude of enterprise contribution to government budget is determined by the exogenous factor of rate of growth in revenues

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18 For an exposition of the diversity between ownership and single corporate presence, see J. B. Heath (1980).

19 In this process, a major philosophical issue is whether government should second guess or review the budgets of enterprises. In their normal approaches, enterprises are not different from spending agencies and, like all other national organizations, they seek to maximize their avenues. They, therefore, need to be reviewed in order to be in conformity with national priorities.
mandated by government and by the endogenous factors of enterprise performance. The former is decided as a part of the plan exercise and within that framework the levels of resources to be generated by public enterprise are estimated. The exercise implies a comprehensive examination of the enterprise's capacity to earn and to determine the share of earnings to be retained and the share to be transferred to government. The analysis will include a consideration of the size and nature of markets, the policy goals of government, existing levels of technology, and the availability and utilization of human skills. These exercises are carried out in the context of the formulation of the development plan at a highly aggregate level and greater specificity is expected in the annual budget exercises. Once formulated, however, they are to be communicated to the enterprises. Available experience points out that resource mobilization through enterprise operations is often the last measure in government priorities for raising revenues and, even in countries where enterprise budgets are fully integrated with the government budget, these are often determined by ad hoc considerations. Moreover, not all governments are empowered to receive contributions from enterprises.\footnote{A distinction should be made between economic rents payable for monopoly positions that enterprises have and dividends or return payable on investment. In Spain, enterprise contributions to government cover both these aspects.} In Sri Lanka specific legislation had to be enacted in the early 1970s to permit enterprises to make contributions. In Korea no dividend is payable to government under the legislation and surpluses are retained by enterprises for further investment. In some countries, lack of forward budgeting and advance corporate strategies meant that the size of the contributions tended to be fixed arbitrarily. Elsewhere, the determination was rendered difficult as the government’s budget review did not cover the revenue budget of the enterprises.\footnote{Similar problems are also experienced in the identification and utilization of internal resources (retained earnings, reserves, etc.) of enterprises.} In some countries, the exercise lacked realism and enterprises had to borrow funds to pay the contributions. In monocultured economies reliance was placed on few enterprises as the major contributors of government revenue. As the cyclical factors influencing the enterprise performance were not taken into account, contributions to the budget suffered and, in the absence of short-term adjustments in expenditures, led to inflationary financing. Variations of these experiences are common and underline the need for a clear
framework that specifies the revenue expectations and the industrial and business strategy that would ensure their accomplishment.

**TRANSFERS TO ENTERPRISES**

The determination of the overall resources to be transferred to enterprises is made with reference to the framework of sociopolitical approaches of government and the role assigned for enterprises in development plans. The size of the resources transferred annually is, in practical terms, based on the price and capacity utilization policies and the expansion envisaged in the capacity. If, for example, price restraint is to be adapted, more resources may have to be transferred to enterprises. There are four main issues that arise in the transfer of funds: (a) whether the capital transfers fit into national priorities; (b) the form they should take—grant, equity, loan, or subsidy when used for current purposes; (c) the extent of self-financing generated by enterprises; and (d) the extent to which NPEs should be permitted to borrow. In considering these areas, three aspects need to be kept constantly in mind. First, while the effects of channeling additional funds to enterprises will depend largely on the form of the instrument, in each case the effects on the enterprise will always be the same regardless of the origin of these funds. In other words, the effect of the form will not change depending on whether these funds originated in the budget, the domestic financial system, or the external sector. Second, the macroeconomic effects of channeling additional funds to public enterprises will not depend on the form of the instruments but upon the origin of these funds and whether such funds imply (or not) an increase in the aggregate demand and credit. If such additional funds are not compensated for by reductions, for example, in credit to other sectors of the economy, total credit increases, causing an expansionary effect on the economy. Depending on the circumstances, the expansion may result in economic growth, inflation, or a deterioration in the external balance. Therefore, the financing of capital expenditure and the financing of operations need to be coordinated in terms of reliance on the government, on the domestic banking system, and on foreign borrowing. Third, the resource needs of enterprises change depending on a variety of factors, including their
cycle of operations, sectoral type of activity, the operating results, amortization of loans, investment in expansion programs. The dynamics of enterprise finances are such that, in the absence of a well-formulated financial policy, the size of the actual available resources could differ from the needs causing inefficiencies and misallocation of resources. Shortage of resources will prevent the enterprises from operating at full capacity, while excess resources could contribute to building up needless stocks and the allocation of funds to nonessential activities. Furthermore, the effects of both tend to be cumulative over a period. Shortage leads to operating losses, which tend to further aggravate the full utilization of capacity and could, over a period and unless rectified, suffer cumulative erosion. On the other hand, enterprises that suffer no such shortages may be able to utilize their resources in more efficient ways by improved research and development and may develop activities conducive to lower costs and higher profits. Thus, temporary setbacks may become a more enduring and steadily debilitating feature, while resources properly endowed and used could lay the foundation for cumulative improvement. For the purposes of our discussion here, however, it is assumed that resource use would be undertaken with normal prudence.

Capital transfers—the initial capital for enterprises and the additional funding for expansion—are made, in theory, after an appraisal of the economic aspects of investment and the specification of the link between the proposed investment, its rate of return, and the necessary pricing policies. Investment programs—including those that are financed by enterprises need to be coordinated at the national level in order to pursue interdependent policies and to ensure their adherence to national priorities. Frequently the lack of coordination between government investment plans and the self-financed plans of enterprises have led to situations where government-owned holding companies acquired units in lower priority areas. While this is not necessarily universal in its occurrence, it is advantageous, however, to plan capital transfers within the framework of a nationally coordinated program. It is equally desirable that comprehensive appraisal is done of the proposed transfer and its place in the financing of the project. Too often, it appears that governments have tended to set investment levels, and thus capital transfers, intuitively rather than by relying on actual market tests or on estimates of market conditions.
Equity/loan

The form or instrument chosen for making the transfer may be a capital grant, a loan, or equity participation in the initial stage or a subsidy during the operational phase. Limiting our focus at this stage to the establishment or the expansion of the enterprise, the relevant instruments are grant, loan, or equity. 22 The implications of each of these forms are different for the government in terms of the new rights and powers of control that it acquires; they are also different for the enterprises, particularly on their cost structures and financing problems. For an enterprise, the implications are of significance, because the composition of its capital structure affects its financial image and, in a broader context, its very ability to raise additional finances. The instruments are, therefore, analyzed from the viewpoint of government as well as of the enterprise.

The terminology of grants, equity, or loan may not, however, fully denote the implications or the actual nature of the transaction. For example, in several countries initial capital may be made available in the form of an advance and its final form may eventually be determined. In Italy enterprises derive their capital from endowments (dotazioni) on which no interest is paid and repayments are made only when net profits are made by enterprises. In practice, however, repayments occur rarely and the endowments become grants. In Korea the initial capital and annual injections of capital for meeting losses are in the form of equity, which, in effect, does not differ from a grant as no dividend is payable. The choice of a grant for making the transfer, although often resorted to, seems to be an instrument that cannot be justified from any point of view except that of the enterprise. From the larger allocative efficiency viewpoint, provision of free capital to enterprises may be justified only when it is recognized as an explicit subsidy. But as capital is provided in most countries without any charge or obligation to repay, it could be argued that if the intent is to subsidize the product or a group of consumers, it could be done more efficiently by other means. Within the enterprise, grants do not become a cost element and the price of the capital will not be reflected. As an extension, because these funds are free, they are unlikely to

22 Viewed from the enterprise angle, its capitalization will consist of four items—grants, equity, loans, and reinvested surpluses. The last category refers to internal resources.
induce any financial discipline. In a narrower sense, grants could perhaps be justified only when the budget is in surplus, which, in any event, is a rare occurrence.

Financial resources may therefore be provided to NPEs either in the form of equity capital or as a loan.\textsuperscript{23} From an economic angle both are to be considered as the nation’s resources allocated to a specific purpose and ought, therefore, to rank as a source of cost relevant to that output or the enterprise. Although this consideration should be dominant during budget review, it seems that it is the least important one, and greater weight is given to accounting and managerial factors. Equity funds involve a risk capital with ownership participation and a role in the enterprise management decisions. They are expected to remain invested in the enterprise for a long term, and if they are remunerated, this would be according to the actual performance of the enterprise. Loans, however, do not imply ownership participation and may not usually have a role in management, except for certain new investment decisions, and are to be repaid according to a prearranged agreement regardless of the financial performance. Loans reflect a temporary resource, which when repaid (unless replaced) could reduce the availability of enterprise funds. Their terms are apt to be more standardized, reflecting market conditions and practices and they will rarely be adjusted to meet the specific requirements of an enterprise. Servicing loans is a cost that is shown in the accounting statements and may lead to lower profits, while where financing is provided in equity form, the absolute size of profits would be larger. Loans allow greater flexibility for the government in the management and rotation of funds. For enterprises that look to the open market for capital, the chances are likely to be much better the lower the proportion of loan capital is to its total capital structure at the time of borrowing. The choice between the instruments is far from easy and typically reflects the larger dilemmas faced elsewhere.

A survey of the practices for equity/loan transfers from governments to enterprises reveals a lack of similarity across the same sectors in

\textsuperscript{23}There is a wide range of other financial instruments with mixed characteristics and not all of them are applicable to NPE finances. Preferred shares, for instance, involve a prior claim to dividends should the enterprises be dissolved. Similarly, secured bonds give the holder a first claim on a designated property; debentures pledge the general credit of the company.
different countries. In the United Kingdom, all listed public corporations carry loan capital rather than equity. In Guyana loans exceed equity, while the reverse is true in Peru. In Tanzania and Uganda loans dominate. In the Philippines all nonfinancial public enterprises have the lowest loan component, while in India loans exceed equity in consumer goods industries; in capital goods industries, equity is dominant.

The aggregates do not, however, reveal the dynamics of budgeting in providing these resources and it is in this respect that more issues are faced. From a budgetary angle there seems to be a natural preference for a higher loan component in government outlays. First, the government’s own funds are largely borrowed and are passed on to enterprises as loans. Second, a high loan component makes the forecasting of government receipts relatively easy, because there is a certainty about the flows of income. There are also, however, several budgetary practices that tend to undermine the policy importance attached to loans by government and the financial performance of enterprises. Many governments lend funds to enterprises without systematically evaluating alternative sources of funds and without careful analysis of the terms and conditions. Short- and long-term loans are made without specific provision for amortization and often have interest rates substantially below market rates. This has led, at one extreme, to an excessive volume of government loans and consequent capitalization in the financial structure of enterprises; at the other extreme, government funds have often become the easy financing option. There are also cases, however, where the cumulative amortization of loans has resulted in enterprises having insufficient funds, reflecting undercapitalization and inadequate working capital. It is for these reasons that enterprise managements argue that loans can adversely affect an enterprise that has a long gestation period, that the fixed interest charge by government can be onerous, and that extensive capitalization adversely affects their ability to gain new business. The government’s point of view is that there are limits to the taxpayer meeting the expenses of the enterprise, that easy finance implies a

24See United Nations, Financing of Public Enterprises in Developing Countries: Coordination, Forms, and Sources (1976), Monograph 2 on "Capital Structure of Public Enterprises in Developing Countries," pp. 33-73.
built-in option for enterprises, and that, as interest is an expense, it is
tax exempt and, therefore, does not burden the enterprise.

Technical arguments advanced by each group have impeccable logic
but they only obscure the basic problem of providing enterprises with
finances. What is the most appropriate way? How can the differing
points of view of government and enterprises be reconciled? Some
suggest, with a view to inducing market-based financial discipline,
that the enterprises should depend on the commercial banking system
or related financial markets.25 This in a way tends to beg the issue of
the rationale of public enterprises. It does not necessarily mean,
however, that enterprises should entirely disregard the markets nor,
given the social role of enterprises, should they be exclusively guided
by the market. More pragmatically and specifically in the context of
government budgeting, the means of financing need to be considered
both in terms of the costs and goals of governments and the capital
costs of enterprises. The experience cited above indicates the necessity
for a conceptual framework that specifies the equity loan ratios for all
enterprises or different ratios for different sectors, whether such ratios
should be observed throughout the life cycle of enterprises, or whether
they should be flexible reflecting the various stages of growth. Once
such a framework is formulated, budgetary decision making would be
less ad hoc and the type of distortions in practices described earlier
would be minimized.

Subsidies

A major issue of transfers relates to the quantification of subsidies
provided to enterprises. This, by its very nature, requires a clear policy
on what to subsidize and at what level. Generally, subsidies are given
for three purposes: (a) to compensate for noncommercial objectives
specified by governments; (b) for price restraint for essential and
strategic items of consumption; and (c) to finance operational losses

25For a recent discussion of this view, see John Redwood’s “Government and
Nationalized Industries” (1976a), pp. 33–46, and “The Future of the Nationalized
Industries” (1976b), pp. 33–44; and Michael Lipton’s “What is Nationalization
For?” (1976), pp. 33–38. It should be noted that market mechanism may not fully
serve the goals of the society. For example, left to the market, enterprises may show a
proclivity to oversubstitute capital for labor, which, while rewarding the enterprise,
may hinder the growth of employment in the economy.

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through ex post transfers. There are also indirect subsidies that may not be reflected in the budget. Reduced interest rates and preferential treatment for government procurement of goods are in this category; there are other transactions that are less transparent and are hidden.\textsuperscript{26}

Compensation for the pursuit of noncommercial objectives is a well-established practice and is most common in the transportation sector when noneconomic routes are used, for transporting schoolchildren, for hauling freight to backward regions. Subsidies for noncommercial objectives are best indicated in advance, so that the enterprise can draw the line between commercial and other transactions. Moreover, it facilitates the proper appraisal of costs and benefits in that the social advantages and the social element in the outlays can be identified. Although there was considerable reluctance in the initial phase of public enterprise development,\textsuperscript{27} it appeared that the pursuit of economic efficiency and social philanthropy imposed unnecessary strains on enterprise management and there is now general acceptance of the need to compensate enterprises for costs incurred in pursuing functions that would normally have been avoided.

Subsidies for selling products or services at a price lower than cost have a long past and have become integral parts of explicit state policies since the French Revolution. More recently, especially during the last decade, compensation for observing price restraint in inflationary periods has become a common occurrence. In addition to subsidies of this type, transfers are also made to cover the operational losses of enterprises after these losses have been incurred. The determination of the size of subsidies of the first two types is made by three techniques: (a) recoupment of the actual expenditure of enterprises; (b) adjustment in the rate of return of enterprises; and (c) specific compensation. The first approach, which has been prevalent in

\textsuperscript{26}One of the problems with which the European Economic Community (EEC) attempted to grapple was whether grants given for new plant and equipment were actually used for that purpose. From the enterprise angle, all funds are interchangeable and it is not easy to establish the specific use of subsidies. For the practices in the EEC countries, see Public Enterprise in the European Economic Community, METRA (Oxford) Study. Also, see Kenneth D. Walters and R. Joseph Monsen (1979), pp. 160–70.

\textsuperscript{27}In the United Kingdom, for example, Herbert Morrison (1950) argued: "It would be wrong to subsidize the socialized industries . . . to do what I have suggested should be expected of them as good citizens," p. 5.
certain sectors in some British Commonwealth countries for more than a century, has the inherent disadvantage of placing the government at the receiving end and the enterprises, for their part, do not have any major inducement to pursue cost reductions.

The second method, although practiced in some arbitrary forms, requires as a first step the determination of the presumptive rate of return. The third method, which has several advantages, appears to be used infrequently and for minor purposes such as cost differentials or when an activity is promoted even though its cost is higher than comparable products. A necessary consequence of the recoupment approach is that subsidies tend to be determined not in advance but after the event. Even where precise indications are given, as for the fertilizer subsidy in India and Korea, the eventual magnitudes do not lend themselves to controls, as prices of inputs and world prices vary from the estimates. Subsidies for price restraint are often budgeted initially on a notional basis and are revised later on the actual basis. This implies that, in practice, subsidies tend to be open ended and, in an inflationary context and where such transfers are quite large, government budgetary outcome differs greatly from estimates.

Financing of losses

Transfers to enterprises for covering their losses in some countries are made as loans, equity, and even subsidies. The problems relating to the choice of the appropriate instrument is, however, subsidiary to the major questions on the nature of losses, their magnitude, the impact on the budget, and the type of policy mix that could be evolved to minimize the problem. Budget review should be more concerned with an analysis of the factors contributing to losses, which, in public enterprises, occur because of the low rate of utilization of installed capacity, uneconomic prices established by government, heavy reliance on borrowing and, therefore, higher costs, capital intensive nature of the enterprises requiring higher depreciation provisions, and higher costs attributable to managerial or operational inefficiencies. Each of these factors requires a different policy approach. In some cases, capital

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28 For an interesting discussion on recoupment and its early experience in Australia, see R. L. Wettenhall (1966), pp. 391–413.
restructuring would be needed, while in others more fundamental solutions are involved when losses were due to a structural shift in demand. However, if transfers are routinely made from the budget, this could lead and, indeed has led, to situations where the burden is transferred to the taxpayer and there would be little compulsion for enterprises to improve their efficiency.

SELF-FINANCING AND BORROWING

How much of the investment made by an enterprise should be self-financed? Self-financing is dependent on the past financial performance of enterprises. Investment is, on the other hand, forward-looking and the coordination of these two involves a detailed review of the budgets of enterprises and their priorities. When self-financing is linked to capital transfers from government, as is often true, the specific capabilities of enterprise to raise resources have to be examined in terms of the pricing and related financial policies. Their economic implications require clear recognition of policy choices. Predetermined self-financing affects the consumer because it leads either to higher prices to cover costs or to increased profits. It also raises the issue of present consumers paying the cost of increased investment for what may benefit only future generations.

Practices in this regard show that self-financing levels are often set arbitrarily and, therefore, have unintended consequences. These levels are frequently not attained, and thus contribute to a slackening in the rate of expected growth of the firm. In other cases, the absence of coordinated investment plans leads either to enterprises having abundant liquid funds or to their building up excess capacity. In some cases, the effects tended to be even perverse, in that investments were made at a time when they added to inflationary pressures and withheld when financing was needed to counteract recessionary tendencies. These aspects underline the need for more coordinated budget reviews.

Another area where leading policy and institutional issues are raised relates to borrowing by enterprises. Two schools of thought are recognized in this regard—those that advocate freedom to borrow domestically and externally, and those that support an integrated or coordinated borrowing program for government and enterprises. The former school believes (a) that there is a need for diversification of
sources of borrowing, (b) that the purposes for which enterprises borrow are different from those of government, and (c) that it is healthy for enterprises to borrow on their own to keep their standing in the market. Such independent borrowing would probably reduce dependence on government budget, induce a better financial discipline, and might be helpful in preventing acceleration of the values of gilt-edged securities. The latter school's opposition to this approach has both ideological and practical bases. Issue of a debenture by an enterprise implies payment of a return to the holders, and such payment, it is contended, is contrary to the purpose for which government funds were utilized to establish the enterprise in the first place. This, of course, is the ideological part of the argument. From a more pragmatic point, it is argued that centralized government borrowing both for government and enterprises has a number of advantages: (a) from an economic point of view, centralized borrowing is easier to control in terms of timing and to assess its impact; (b) that it could be costlier for enterprises to borrow independently, as their borrowings are often for shorter periods than that of the government and the yields have to be higher; (c) that as these borrowings carry on explicit or implicit government guarantee, they would not attract new risk capital other than that already destined for the public sector; (d) that if the enterprises borrowed in the form of stock issues it would complicate the management of the gilt-edged market, particularly when the government budget is to be financed by nonbank borrowing; and (e) that centralized borrowing allows enterprises to make premature payments to government, which they could not if they had borrowed from the public in the form of stock or from a bank, except with a penalty in the case of the latter.  

Public enterprises now borrow nearly a fourth of their total borrowing from international markets and half of this is accounted for by borrowing by developing countries. It is, therefore, suggested that centralized borrowing by government better appraises market opportunities and servicing capacities. Actual practices, however, vary and indicate that this is an area where more concerted efforts are needed. In the United Kingdom, borrowing is central and controls are exercised to limit external

29 For an extended discussion on this, see United Kingdom, *The Nationalised Industries* (1978).
financing. In France enterprises borrow in domestic and foreign markets but always with the approval of the Ministry of Finance and National Economy. In India and Korea enterprises cannot issue stock to the public and all long-term capital is provided by government or its financial institutions. In respect of foreign borrowing, similar restrictions apply and government approvals are needed. In Portugal enterprises can borrow externally after informing the central bank but without any specific approval from the Ministry of Finance. In some countries, controls on foreign borrowing appear to be lax. For example, in Ivory Coast, although regulations require consultation, the Caisse Autonome d’Amortissement has not been effective in preventing borrowing from abroad. In some countries, finance ministries became aware of foreign borrowing only after the event and arrangements had to be made for the servicing of the debt. In the United States, several public enterprises at the state and local level borrowed extensively from the markets with guarantees provided by government and, as some of them could not service the loans, repayments became the responsibility of the relative state governments.

PRICING POLICIES AND PRACTICES

The financial performances of enterprises revolves around the pricing policies because, in the final analysis, if there is one factor that has the most impact on enterprise finance it is the pricing policy. The recovery of the loans extended or the possibility of earning a return on investment is dependent on the use of the resources transferred from government and the prices charged for enterprise products and services.

The price theory of firms has been debated considerably and the

30 Such limits are expected to reduce the administrative dependence of enterprises on government and to promote more responsible management. See United Kingdom, “Financial Control of Nationalised Industries (1980b), pp. 6–7. In practice, however, the dependence of enterprises on the Treasury tended to be even higher with changes in the market climate or in the rate of predicted inflation. In the event, the dependence also contributed to more budget expenditures and increases in the public sector borrowing requirement.

31 This was particularly true in New York State. For an account of this, see Anne Marie Hawk Walsh (1978).
debate continues. For more than five decades, there have been discussions on whether the principles of marginal costing have been an "empty box" or not. These arguments are extensive and it is not intended to discuss them here. The purpose here is merely to enumerate the general theories of pricing and their current status and implications for government budget and enterprise finances. Pricing practices are also briefly considered, with particular reference to the belief that prices are no longer considered as being determined either by costs or prices but by the public interest and the state of the cash flow of the public sector as a whole.

Adopting the general principles of pricing of the neoclassical concept of a firm, it appears that three main factors influence the prices of public enterprises. These are the market structure, the type and category of goods, and the nature of the economy and its horizontal and vertical linkages for a specific commodity. Enterprises may produce intermediate goods or goods for final consumption, and may sell to the public, to other public enterprises, or to government and may experience, in some cases, near-monopoly conditions while elsewhere enterprises may compete with other private enterprises. The pricing alternatives available to enterprises are opportunity cost base pricing, marginal cost-marginal revenue pricing, marginal cost pricing, average cost pricing, and cost-plus-margin pricing.

The most important objective in pricing goods and services is to ensure efficient use of the economic resources required for their production. Any use of resources involves an opportunity cost in terms of the alternative uses that have been forgone. In the absence of explicit reasons to the contrary, prices paid for goods and services should ideally cover the costs of the factors of production. The nature of the opportunity costs relevant to public enterprises are, however, different, as they relate to the social opportunity costs or the costs incurred by the society as a whole. In certain instances, these costs may differ from the private costs reflected by the market prices paid for resource inputs. In practice, the quantification of such allocative charges or benefits raises a number of difficult issues. As the capital invested in an enterprise is itself a resource input, it can be expected that the capital employed will earn a return equal to its opportunity cost. By estimating the opportunity cost of capital in the economy, as reflected by the rate of return that is earned by alternative investments, and by taking into account the various factors that might influence the...
expected return to capital, the actual performance can be used to deduce whether pricing policies are consistent with efficient resource allocation and other government objectives. If prices are different from desired levels, it is expected that the financial effects of these variations are, as far as possible, explicitly budgeted so that the costs to society are known. This approach represents an ideal and is useful as a guideline. Its main limitation lies in abstracting market conditions, in particular, demand aspects.

The traditional marginal cost and marginal revenue approaches are in a way covered by the above principle. In sectors where there are large investments and in enterprises that work under near-monopoly conditions profit maximization takes place when marginal cost is equivalent to marginal revenue. The application of marginal cost pricing also offers an efficient pricing rule but when considered as a separate entity, it does not reflect the demand aspect. Both these approaches have been debated extensively for a long time and major problems appear in their application. Specifically in regard to public enterprises, public and consumer interests may militate against profit maximization for its own sake. Also, in an industry where marginal costs are increasing and where the difference between average and marginal costs is substantial, it could lead to unreasonably high profits. If prices are fixed with reference to declining marginal costs (which is generally true for public utilities), it can mean that they may not cover the average costs and will contribute to losses. Also, marginal costs do not lend themselves to easy quantification. For one thing, the marginal product is not itself often identifiable and the computation of marginal costs is, therefore, neither simple nor specific. Efforts made in industrial countries reveal that such computation is expensive and computed marginal costs are not very different from average costs. Marginal costs are dependent on the capacity utilized, which is based on demand, which, in turn, is based on marginal costs. These costs are variable over time and are influenced by several factors, including technology, nature of the market. On the

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32 The opportunity cost of capital may be higher in a developing economy because current amounts of investment are lower than the opportunities available.
33 For a comprehensive discussion of the application problems, see United Kingdom. A Study of the U.K. Nationalised Industries (1976b).
34 To mitigate some problems, a concept of iterative marginal cost has been developed, corresponding to the French marginalist school concept of "cout marginal
whole, however, marginalism continues, even if elusive in practice, as a major theoretical base for the determination of prices, not because of its practical applicability but mainly for the reason that no theoretically viable alternative has been advanced.

The average cost concept is often favored for public enterprises, mainly for two reasons. At an aggregate level, it implies the achievement of a no-profit, no-loss objective. At a more specific level, it facilitates the activities of enterprises that produce a mix of consumption and intermediate goods. It is, for example, very difficult to apply the concept of marginal costs to commodities or services that distinguish different income groups (such as railways) or types of products (such as postal services for inland and foreign mail; mail within a country, following the Hill principle, costs the same regardless of distance). Average costs are easier in such cases, but admittedly are not allocatively efficient, except when they are equivalent to marginal costs. In practice the pricing of public enterprises has been based on accounting costs or cost plus reasonable margin. These terms are variously defined but generally include a socially desirable rate of return on capital and appropriate provision for the service of capital, reflecting amounts for replacement and selective expansion (including those induced by changes in technology). These accounting costs, in turn, have to be comprehensive enough to incorporate the impact of cross subsidization and changes for peak and off-peak usage. The use of the social rate of return is a delicate task and care should be taken to ensure that it does not become a basis for rationalizing failures or for obvious mismanagement.

The experience in this regard illustrates that the market environment is not a textbook abstraction but covers the legal framework, institutional practices, tax/subsidy incentives, degrees of economic power exercised by participants, and information available for decision making. It also reveals that in both industrial and developing countries there are extensive systems of administered prices that may be evolved by specialized bodies working on a regular basis within the government or ad hoc bodies appointed for the purpose. Prices are determined both for the public and private sectors on a common basis and are

à longue terme de développement," but the marginal costs developed under this procedure may not be the ones to fully reflect the imperatives of allocative efficiency. See Ralph Turvey (1969), pp. 284–99.
generally so formulated as to provide a remunerative rate of return on the capital. The cross-country experience reveals some broad features of price determination. (1) Tariffs of public utilities, which are expected to have a greater role in the promotion of social welfare, involve generally, an element of subsidy by the government. (2) Prices for basic materials may also be subject to government control regardless of the ownership of enterprises. Included in this group are steel, chemicals, and fertilizers. (3) Prices of public enterprises whose products are sold to the government or to other public enterprises are determined by negotiation with the government. However, when the policy is to provide cross-subsidization, the subsidy becomes a part of the government budget. (4) Prices that are fixed by market forces. Within these approaches, the import or export prices of items are used as guidelines for the determination of administered prices after appropriate adjustment for the social welfare function. From the viewpoint of the government budget, it is important that the implications of the first three categories are determined in advance.

Ideally, it is expected that such advance determination would be adequate for ensuring budgetary stability during a given year. In practice, however, this has been very difficult during recent years because of higher inflation rates. Governments have tended to use the pricing policies of public enterprises as an optional technique for restraining the rate of inflation. This is particularly true for strategic and basic materials such as steel and fertilizers. In the United Kingdom, such an approach was particularly popular during the early 1970s. Similar experiences in other countries are legion. In the United Kingdom, public enterprises were compensated for the pursuit of price restraint by a reduced rate of return, while in other countries subsidies were paid to both public and private enterprises. In some countries, where approved prices cut into the profit margins of private firms, suitable adjustments were made in tax provisions for depreciation, so that the overall effect could partly be mitigated. These approaches caused a widening of the budget deficit, which in the event had to be financed through borrowing. It is a moot point whether the overall policy goals were served at all, for any restraint on the inflation rate achieved through price policy is offset by the increased money supply flowing from higher budget deficits. In several countries, when budget deficits threatened to become major problems, hurried adjustments were made to make marginal increases in prices but always with a lag.
To the extent there is coalescence between government and public enterprises to achieve stabilization, it is essential that the continuing impact of the latter on the government budget is reviewed at each stage. It also suggests that in such situations prices cease to be based on costs (although parity would be maintained) and have more relevance, even if debatable, as anti-inflationary measures. The choice between initial price restraint and eventual inflation, on the one hand, and free play of market forces and formulation of prices reflecting the full costs, on the other, is a difficult one and is influenced by a variety of factors that are admittedly not economic in character.

CONTROL OF ENTERPRISES AND AGENCIES

The primary concerns of the government in relation to enterprises and agencies as illustrated in the budgetary process are threefold—to inquire (a) whether they have been contributing their share to the budget or to the financing of their own and other investment plans, (b) whether resources are being used in a manner consistent with goals of allocative efficiency and stabilization of the economy, and (c) whether, in the event of overriding social objectives, their impact on enterprise and agency finances has been identified and quantified. The answers to these questions are provided but only partly by the budgetary process. Supplementary control mechanisms are, therefore, used for the purpose. The factors that have influenced the framework of controls are not merely financial in nature but reflect broader concerns.

Since the pioneering work by Berle and Means, a good deal of ground has been covered in literature on the growing gap between ownership and control and the methods that could be adopted by shareholders to gain control over the activities of corporations. The role of the government is, however, different from that of a shareholder. It is a role that transcends the narrow concerns of the shareholder and reflects the concerns of the major financier, the development planner and promoter, manager of the economy, and arises from the government's function as a protector of the consumer's interests. The need for government control stems from the more specific functions that occur in performing these varying roles. As a coordinator, the

See A. A. Berle and G. C. Means (1932).

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government has to assess the linkages of the enterprises and agencies with the rest of the economy and has to coordinate their activities. In this broad sphere it assumes the role of a player as well as a referee and neither role can be performed to the exclusion of the other. Government has to ensure that the correct methods are adopted by the enterprises to achieve their specified objectives. Moreover, in certain spheres where public enterprises have a monopoly, government has to ensure by controls that the advantage is not taken by enterprises in a way contrary to the interests of the community and, finally, controls are needed as a feedback mechanism in the government to fulfill its own role as a manager of the economy.

GROWTH

Reflecting the above concerns, a wide network of control systems have evolved. Their growth indicates three distinct phases. The first phase was the era of the arm's-length principle (also known as the Morrison formula), which basically sought to reconcile the needs of autonomy of enterprises, on the one hand, and accountability to government and parliament, on the other. The autonomy requirements of entities reflected the basic recognition that there must be quick decisions in business, that government officials may not be able to make the right decisions, and that conducting a business involves risk taking that may not be possible within the traditional government environment. This principle was adapted in various ways to the requirements and the constitutional setting of the country concerned. Where there was no legislative accountability, as was true in some Latin American countries, appropriate adjustments were made to suit the presidential systems of government. This framework, however, was soon found to be inadequate and generally less flexible in meeting the growing requirements of government. Development planning and demand management of the economy have made imperative regular consultation between government and enterprises. Also to achieve the diverse tasks, control measures combining managerial, efficiency, and economic considerations were evolved and implemented. This phase, which is the second one, implied abandoning the arm's-length principle and resorting to controls that occurred frequently and included restrictions on credit, investment, and pricing policies. In effect, the pervasive nature of the controls was such that the dividing
line between government and enterprises was not visible and there appeared to be a seemingly indivisible structure of decision making and control. While this may have served some purpose, it was the associated problems that deservedly got more attention. It was recognized that national interests were to be served by enterprises and that controls were essential for the purpose. The issue was whether such controls have to be exercised to the point of becoming counterproductive. As governments and enterprise management became interchangeable terms, controls became extensive and could not be distinguished from interference. Apart from the fact that this dampened the enthusiasm of enterprises, it also became evident that government agencies could not properly reflect market conditions and the dilatory procedures of government have, on the whole, adversely affected the performance of enterprises. The recognition of these problems led to the third phase, in that there has been an increasing momentum to develop a framework of objectives with a specification of a rate of return, leaving the enterprises with the operational freedom necessary to manage themselves within given parameters. The third stage of development is still limited to only a few countries and is, in a way, a return to the arm’s-length principle but with a more elaborate specification of the economic and commercial terms and policies of the enterprises. The arm’s-length principle, by its nature, was more hierarchical, bureaucratic, and unidirectional, while the third phase essentially emphasizes the assignment of financial and organizational responsibilities.

The control of autonomous agencies has not kept pace with the above developments. The primary problem in controlling them appears to be felt more at the government end than at the receiving end. The large number of agencies (although, in terms of financial implications to the budget, they were minor compared with enterprises and social security agencies) led to the inevitable fragmentation in decision making, which was rendered even more difficult where the agency functions and finances were preserved in the constitution. Government controls were, therefore, largely confined to those that arise in the budgetary process.

ANATOMY AND WORKING OF CONTROLS

Reflecting the above-described three stages of growth, a vast spectrum of controls has evolved. Controls so exercised are both formal
and informal. The latter are generally invisible and are exercised in subtler forms during the budget review but are far more decisive in their impact than formal controls. The nature and purposes of these controls are illustrated in Table 26. In considering the exercise of controls, a distinction should be made between the statutory, personnel, and budgetary approaches, on the one hand, and the economic and evaluative controls, on the other.

The controls enumerated in Table 26 suggest that they are extensive and can meet any contingency. In practice, however, not all these controls are to be found in countries. Also, the exercise of controls is dependent on the operating environment in each country and is closely linked to the prevailing approaches to decision making, the types of communication available, the motivation of those who are responsible for the exercise of controls, and the type of leadership used in the process. More recently, in view of the numerous problems faced by enterprises, control mechanisms have been the subject of extensive discussion and the analysis of the issues has followed predictable, albeit traditional, lines. Management analysts, concerned as they are with the organizational processes, the role of individuals, their power, and established patterns of behavior, suggest that there are too many strata of control in the government. It is further pointed out by these analysts that the responsibilities for controls are vested with minor functionaries who have no background of enterprise management and that, in general, there is no policy direction.

A more frequent comment is that control became an euphemism for excessive and whimsical ministerial interference. Such interference could be due to the lack of a policy framework or, alternatively, could refer to situations where, despite the availability of a framework, frequent consultations with and policy guidance from government is needed because uncertainties and volatilities in the economy make essential periodic departures from the policy framework. This, in turn, leads to greater dependence on government. In most developing countries, public and private enterprises work in an environment in which the supply of strategic materials is controlled by government. When enterprises incur losses, which happens to be true for most of them, there is a general shift of decision making to government as the latter has the responsibility for developing measures intended to improve the financial condition of enterprises. Such direct management only adds to the excessive government control already prevailing.
Table 26. Government and Nonfinancial Public Enterprises and Agencies—Structure of Control

<table>
<thead>
<tr>
<th>Type</th>
<th>Nature of Controls</th>
<th>Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formal and organizational</td>
<td>Statutory</td>
<td>The broad spectrum of relationships and controls are specified in the relative legislation. Autonomous agencies frequently invoke this aspect to resist government controls</td>
</tr>
<tr>
<td>Executive</td>
<td></td>
<td>This relates to the powers of governments to appoint chief executives and members of the boards of management</td>
</tr>
<tr>
<td>Emergency powers</td>
<td></td>
<td>Legislation concerning some enterprises endow governments with operating power providing specific guidance in emergencies</td>
</tr>
<tr>
<td>Policy directives</td>
<td>Arm’s-length principle implies that ministries are not responsible for the day-to-day operations of enterprises. Where necessary, specific directives may be given concerning prices, production costs, social goals</td>
<td></td>
</tr>
<tr>
<td>Annual and other reports</td>
<td>Annual reports of enterprises are reviewed by governments and frequently submitted to legislatures. This review provides an opportunity to evaluate the overall performance of enterprises. Similar requirements are there for autonomous agencies, as well to obtain the prior approval of the government even where formal budget provision exists</td>
<td></td>
</tr>
<tr>
<td>Informal</td>
<td>Moral suasion and other pressure</td>
<td>Governments also use pressure informally to influence enterprise and agency policies. These opportunities generally arise during the budget preparation stage. Government has no leverage where agencies are endowed with earmarked revenues</td>
</tr>
</tbody>
</table>
Table 26 (continued). Government and Nonfinancial Public Enterprises and Agencies—Structure of Control

<table>
<thead>
<tr>
<th>Type</th>
<th>Nature of Controls</th>
<th>Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>Appointment of civil service members as managers</td>
<td>In a number of countries, enterprise managers are appointed from the Civil Service. Their recruitment careers are managed by central personnel agencies of governments. In some cases, creation of the top-level posts in enterprises requires the prior approval of government. These powers enable governments to have greater control, both direct and indirect, on the management of enterprises.</td>
</tr>
<tr>
<td>Budgetary</td>
<td>Approval of budgets</td>
<td>In some countries, draft budgets of some enterprises are required to be approved by government.</td>
</tr>
<tr>
<td></td>
<td>Contributions, new investments, self-financing ratios,</td>
<td>Where budgets are not required to be approved by government, selected transactions relating to transfers from and to government are determined in the annual budgetary process.</td>
</tr>
<tr>
<td></td>
<td>subsidies, write-off of loans</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Release of funds and related cash management</td>
<td>Governments enforce a number of controls in the course of releasing the already budgeted funds. In some cases, disbursements within enterprises are also regulated by government personnel.</td>
</tr>
<tr>
<td></td>
<td>Borrowing</td>
<td>Long-term borrowing from domestic financial institutions and borrowing from foreign sources, with or without government guarantee, require prior government approval.</td>
</tr>
<tr>
<td></td>
<td>Approval of specific expenditures</td>
<td>Proposals for expenditure over specified ceilings are required to obtain the prior approval of government.</td>
</tr>
<tr>
<td>Economic</td>
<td>Framework of economic objectives and rates of return</td>
<td>Governments announce advance plans specifying the economic role of enterprises and the target rates of return.</td>
</tr>
</tbody>
</table>
### Table 26 (concluded). Government and Nonfinancial Public Enterprises and Agencies—Structure of Control

<table>
<thead>
<tr>
<th>Type</th>
<th>Nature of Controls</th>
<th>Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic (concluded)</td>
<td>Development and stabilization plans</td>
<td>Plans for economic development and stabilization programs specify the role of enterprises. These include the specification of levels of production, standards of service, type of technology used, manpower levels. In some cases, these targets are evolved in close consultation with enterprises</td>
</tr>
<tr>
<td></td>
<td>Efficiency management</td>
<td>To ensure economic use of resources, productivity factors, and related efficiency yardsticks are prescribed by government</td>
</tr>
<tr>
<td></td>
<td>Credit restrictions</td>
<td>As an integral part of stabilization policies, limits are set on the availability of short-term credit from the banking system. In some cases, banking institutions are also entrusted with selective overseeing responsibilities on the domestic and foreign borrowing by enterprises and agencies</td>
</tr>
<tr>
<td></td>
<td>Inquiries by economic and regulatory bodies</td>
<td>Price commissions and other regulatory commissions appointed by government frequently review selected aspects of the work of enterprises</td>
</tr>
<tr>
<td></td>
<td>Consultation and evaluation by central coordinating agencies</td>
<td>Specialized bureaus in the government perform the role of consultant to NPEs in respect of common matters affecting them. Annual reports on such operations are also submitted to the legislature</td>
</tr>
</tbody>
</table>

These aspects illustrate the delicacy involved in a fragile relationship, where a movement in either direction is likely to be misconstrued depending on the angle from which the situation is viewed. Too often, excessive control by government has been used as a bogey to explain away the enterprise's lackluster performance. More significant is the
fact that, if there are situations in which controls are probably tight and that leave little or no discretion to the enterprises, there are other situations where enterprises have become too independent and have remained impervious to the economic management requirements of governments. If extensive controls engendered lack of trust and accountability became questionable, inasmuch as there was externalization of decision making, the lack of controls has admittedly made difficult the functioning of government. The future needs may be a relaxation of Argus-eyed controls in some cases and a modest beginning toward establishing a semblance of controls in others.

**ALTERNATIVES**

The problems associated with exercising controls have received considerable attention from both academicians and legislative committees and several suggestions have been made for improvement. Some suggestions are more philosophical in nature, while others are exclusively oriented to institutional aspects. The former suggestions consider the control problems being experienced as due primarily to centralization and excessive bureaucracy and that the situation could be improved by greater delegation of power and by making managements responsible for prices, wages, product mix, and the overall performance of enterprises. In this view, the villain is government ownership itself and what that ownership implies in terms of acquisition of control. Administration becomes an end in itself and its attendant consequences will very soon be felt. The alternative is to divide the public enterprise into several decentralized units so that, left to themselves and untrammeled by restrictive government controls, these units would continue to maximize their profits. This approach, however, ignores the fundamental features of public enterprises, particularly their social and economic functions and as fiscal instruments. More practically, it is evident that some activities are organized as public enterprises on the premise that there would be economies of scale, which would be lost if they were to be divided. For enterprises operating in a competitive environment, such decentralization would not be needed. The benefits of competition are, however, not always empirically verifiable and, if any, would depend on the efficiency of competing firms and may not be relevant when there are a few large
firms with decreasing costs. The question could also be raised whether centralization per se is undesirable. There are obvious examples, as in France, where, notwithstanding a highly centralized control, its possibly adverse impact appears to have been substantially mitigated when concerted approaches have been adopted. There are also cases where the evidence is not conclusive in suggesting that decentralization and greater delegation of managerial powers are either welcomed or utilized by enterprise managements.

Technical or institutional suggestions aim at improving the working of controls by modifications in the organizational structure. These suggestions are rooted in the belief that specialized agencies or forms that are consistent with the requirements of public enterprises would provide more purposeful control and less friction between government and enterprises. One of these suggestions relates to the establishment of a separate ministry for public enterprises and is obviously based on the Italian experience. Such ministries existed in one form or another in Malaysia and Turkey, while in Zambia the experiment was abandoned. In Pakistan the major corporations were placed under the control of one ministry but later these were decentralized. A separate ministry would have greater functional relevance where the size of the public sector is relatively small and where the number of enterprises is manageable enough to be controlled by a single agency. The arrangements will permit specialization and consistency in ministerial control. But particular care needs to be taken in delineating the functions of such a separate ministry and, the relationships that a ministry will have with enterprises, within the government, and with other central agencies. A single ministry may

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This should not mean that there is no place for competition. The important goal of a public enterprise is to secure markets and provide services to customers at lowest cost. These goals can also be achieved by careful planning. It is the responsibility of enterprise management to do this. Planning should not be viewed as an alternative to competition but as a process that incorporates market signals into significant decisions. Competition by itself will not achieve this purpose.

The Select Committee on Nationalised Industries in the United Kingdom suggested at one stage the creation of a ministry of nationalized industries. As envisaged in this proposal, regulatory functions (with the relationships being the same as with private companies) would be vested with the subject ministries, while financial and economic controls would, respectively, be administered by the Treasury and the new ministry. It is, however, very difficult in practice to separate financial
help to bring together the ownership and control into a coherent unit but by itself it can solve only part of the problem. As noted earlier, the strata of control and the diffusion of power are only two of the many problems associated with control. An institutional device can be successful only if it is also accompanied by relevant changes in the policy framework.

A more acceptable form of specialization at the enterprise end is provided in the sector corporations that bring together various enterprises working in one sector under one top management. Large sector corporations were formed in Bangladesh, India, Pakistan, the United Kingdom, and Zambia. These provide a viable form of organization in situations where there are many small enterprises operating in the same sector. This consolidation helps communication and, from the point of view of the government, could be considered convenient and desirable. However, it appears that sector corporations could become powerful in themselves and can often substitute for the role of the sponsoring and central ministries. Control is thus exercised not by the government but by the sector corporations—a feature that changes the balance between government and enterprises. More significantly, the political and legislative accountability functions became suspect as they remained only in name with the government, while substantive controls were exercised by the sector corporations.

Yet another suggestion implemented in a few countries relates to the organization of a central bureau within the government to supervise and coordinate the activities of the enterprises. One such example is the Bureau of Public Enterprises, which functions as an integral part of the Finance Ministry in India and as a clearinghouse and which performs a wide variety of roles (in some instances shared with other agencies) such as investment, performance appraisal, policy coordination, wage negotiation, selection of personnel for staffing enterprises, and acting as an arbitrator in specified areas. Its role consists of disseminating information instead of exercising any controls that continue to be vested by the administrative and central ministries. Even this technique is viewed with traditional wariness by enterprises and is considered in some quarters as an additional stratum of control. In Korea, when an attempt was made in the early 1960s to establish controls from economic ones. The proposal was, in the event, considered to be irrelevant. See David Coombes (1971), pp. 159–62.
such a bureau, it was strongly resisted by both enterprises and sponsoring ministries. Even in India the establishment of the Bureau led to the formation of a countervailing organization in the form of a standing convention of the enterprise managements.

There recently has been another suggestion in the United Kingdom to establish a policy council, separate from the corporate board, whose functions would be to formulate and determine corporate aims and the strategies needed to attain them, to lay down criteria relevant for each enterprise's performance, and to endorse corporate plans, annual budgets, pricing, and cost assumptions. The council, as recommended, comprises the representatives of the main interest groups (government, enterprises, and workers) and is, in effect, expected to provide the necessary guidance on the management of their activities to the boards of enterprises. The main advantage of such a council was to bring together the parties involved. Beyond that, however, it offered more potential problems than solutions in that it would have become a supramanagement body effectively superseding the government and preventing it from exercising its own legitimate role. The proposal also relies far too heavily on corporate strategy as a panacea for all problems. In the event, it was rejected.

The suggestions and the responses to them illustrate that there is no single formula that is acceptable to all and that eases controls. The constant refrain of control is to ensure that the aims, policies, and performance of enterprises is in conformity with government goals. Such controls should not be based on short-term expediency so as to become a continuous stream of government intervention but should aid the economic management tasks. The philosophy of control should be based on concurrence rather than on disjunction. Some of these elements are contained in the economic evaluation framework, which, in a way, shifts attention from the exercise of the minutiae of control to its broader purposes.

EVALUATION OF ENTERPRISE PERFORMANCE

A framework specifically evolved for the purpose of evaluating enterprises serves the control as well as other purposes including that of

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providing an incentive to enterprise management. Evaluation
presumes the existence of ex ante objectives. The need for objectives for
public enterprises can be argued both from a negative and from a
positive point of view. From a negative angle, the absence of objectives
implies a lack of clear understanding of their role and when they
should be doing what. Obviously this cannot be met by a vague and
routine incantation of the need for enterprises to adopt commercial
approaches. State enterprises have multiple objectives and if any or all
of them are to be served, the preference function of the state should be
revealed in as specific a manner as possible. From a positive point of
view, the government’s investment vests it with a proprietary interest
and thus, with anticipation of a return. Ownership by itself will not
yield a return unless a formal structure of objectives is provided to the
organization, as well as a good deal of financial freedom. Also, the role
of the enterprises in national economic management makes it
obligatory for the government to indicate the adjustments it is
prepared to make in its own forecasts. Although the need for objectives
alone is not seriously questioned, the difficulties in evolving such a
framework have prompted many to fear they might lead to further
problems and solve none. Some suggest that the movement from the
grand abstractions of allocative efficiency to operational goals is
fraught with many conceptual and measurement issues and, once
formulated, evaluation criteria might tend to be rigid and might
reduce the initiative of the enterprise management in attending to its
own business. While some of these apprehensions are not without
merit, it appears that what is at issue is partly the content of the
objectives and partly the way in which they should be evolved. 39 To an
extent, the enthusiasm of some may also have been partly dampened by
the experience of the United Kingdom, 40 which has tried over the

39The frequently held view is that enterprises have multiple objectives, that they
are difficult to quantify, and that agreement on trade-offs or relative weights to be
attached to different objectives is not feasible. In practice, however, this is not as
difficult as it seems. Noncommercial objectives are more often existential in the sense
of justifying the investment decision itself and, operationally, some of the techniques
described in the earlier sections of this chapter are found to be adequate to quantify
the financial implications of noncommercial objectives. Care should be taken,
however, to ensure that not all enterprise losses are considered as public benefits.

40The Government of the United Kingdom issued three White Papers (1961,
1967, and 1978) in this regard. They mark three different stages in devising a system
of control over public enterprises. For an analytical assessment of the 1978 guidelines,
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therefore, guidelines have to be provided on the measurement and treatment of depreciation, the measurement of assets, and related aspects. Different approaches in regard to some of these technical aspects can change the values of reported return and can be misleading. The rate of return as envisaged in this framework is the result of the work of several factors and should be considered as meaningful only in revealing the aggregate picture. It cannot reveal whether the poor or good performance is due to price, organizational or other factor, and the determination of the contribution of each group of factors requires separate, and presumably more substantive, analysis. When deficits are incurred, they need not necessarily be considered as reflections of failure. In some cases, they may be a prelude to a new era of better performance or wider markets. The framework should, therefore, specify the nature of the return expected over a period and should be cognizant of the shifts during the short and medium terms.

Exclusive emphasis on financial performance may become a red herring and thus detract from the other important issues of efficiency. Such issues frequently have been seen as crises in management and therefore greater attention has been devoted in the literature to the structural elements of organization and how these influence the flow of signals for increasing or reducing work. This, however, reflects only a part of the picture. Another aspect that has come to be used as the basis for evaluation, although in the noncentrally planned economies the experience is limited to two industries in France (and, to a lesser extent, in Senegal), is the one relating to the measurement of productivity (productivité globale des facteurs). This measurement offers a basis for providing incentives where needed but has tended to be viewed with some concern by participating labor unions. The application of the measurements is seldom automatic and makes sense only when these measurements are used in full awareness of their scope and limitations and of the internal and external conditions of the operating assets and excludes the investments on construction and other activities that have not yet become operational. In some countries, it is calculated with reference to the net worth only. Each of these approaches captures only some of the aspects and their choice is dependent on the purpose expected to be served.

42 The approaches of the economist and accountant are different in this respect. The former rearranges the data in terms of a constant series and aims at assessing the alternative yields of investment. The accountant’s approach relies heavily on the balance sheet and aims at presenting the picture at a given time.
enterprise being assessed. Misuse of the measurements can quickly lead to loss of confidence and respect for them and may very soon be used for proving a success even when this is not true. On the whole this is an area that has a great potential and, in view of possible abuses, measurements are best used in conjunction with other economic and financial targets instead of independently.

The framework for evaluation should preferably be evolved in consultation with the enterprises and should seek to highlight the totality of the performance of enterprises. It should not be so elaborate as to reduce the initiative of the enterprise management and should have minimum transaction costs. The introduction of such a framework will require clarity about government objectives and, at a more practical level, may need changes in the accounting and reporting systems to help monitor activities.
State and local governments may be inclined to the view that their own budgetary activities have minimal effects on the national economy. But their role, always important, has become crucial during recent periods and the combined financial decisions and fiscal behavior of all of them have a powerful impact on the economy. It follows, therefore, that greater attention needs to be paid to their role, to the broad relationships between the central and other strata, and to the problems of intergovernmental fiscal management. Traditionally, these problems were studied as a part of "federal finance," which, in fact, paid more attention to the legal and constitutional aspects of the revenue sharing arrangements than to the numerous facets of budgetary or fiscal management. While those facets continue to be important, the focus of this chapter is limited and is concerned with the role of the state and local finances in economic management, the instruments available to the center to transfer resources and to ensure fiscal discipline, and consideration of the issues in each sphere.

1 The definition of a federation itself has not been without problems. Wheare defined a federal government thus: "By the federal principle I mean the method of dividing powers so that the general and regional governments are each, within a sphere, co-ordinate and independent" (K. C. Wheare, 1963, p. 10). So defined, however, it could be criticized by those who believe in a law that limits the discretion of government, for Wheare's approach implies that either party is ultimately subordinate to another, or both are subordinate to a supreme power. In partial recognition of this, Wheare amplified his statement to the effect that "[i]f a
DIVISION OF RESPONSIBILITIES

The division of responsibilities between the central, state, and local governments has always been one of the major problems that have for a long time intrigued students of both constitutions and economics. Although in the final analysis the functions and resources allocated to these three levels of government may be decided by political expediencies, consideration of economic efficiency also plays a substantial role. The economic rationale for the division of responsibilities can best be examined as concerns of supply, demand, distribution, and macroeconomic management.

The supply aspect deals with the provision of public and merit goods and services and is primarily considered in terms of the externalities and economies of scale involved in their provision. Externalities occur when a good produces benefits or costs that accrue to other jurisdictions, as well as to the residents of the supplying jurisdictions. Such externalities may lead to a tendency on the part of taxpayers to reduce their expenditures in order not to incur expenses for services that benefit other areas. In due course, this would contribute to a reduced supply of public goods and services. To avoid such situations and to sustain the supply of public goods at the level required, two measures are envisaged. The first is the traditional administrative solution to centralize the allocative responsibility for all public goods and services with significant externalities. Such centralization will enable the relevant level of government to incorporate the externalities. From a more mundane point of view, it could be argued...
that, irrespective of the concern of the taxpayer about the spillover of the benefits of his contributions, certain services may have to be centralized as they are best rendered on a national scale (e.g., defense). The second measure is to provide a grant from a common pool to compensate the recipient jurisdictions for the externalities and to induce an increased supply of public goods and services. Another factor that provides added strength for a greater degree of centralization is the economies of scale. Where there are major investments for providing commodities and services, it is desirable that the latter be organized on a scale so that costs per unit decline as output increases. Production of power, transportation, and communication facilities are provided more efficaciously when they are organized on a national or regional basis instead of on the basis of smaller jurisdictions.

Consideration of the supply factors will, however, have to be tempered by a recognition of the demand side factors, which are equally forceful. The most important consideration is that responsibilities should be so divided that the public will perceive the link between the demand for additional public services and the need for bearing their costs. Viewed from this angle, the decentralized government levels such as state and local have distinct advantages over national levels, particularly in large countries with populations that are divided by language and other factors. Decentralized services have, in theory, better opportunities to reflect the choice and diversity of needs. Preferences for public goods vary among regions and the decentralized government levels, being closer to the people, are more competent in deciding the most appropriate means for providing services. Such close links have the potential for inducing greater involvement of the taxpaying public. The close involvement is not, however, without its problems and brings with it the full play of public interest economics. It may be difficult, for example, for regional and local governments to resist pressures of the economically powerful local groups whose influence may lead to increased expenditures, to the adoption of priorities that may have deleterious effects on contiguous areas and are in conflict with the policy approaches of the national governments, or to considerable reductions in services in selected areas despite a demand for such services. Another limitation is that, if a state or local government were to decide to borrow from the public or from financial institutions, its credit ratings will probably be far less favorable than those of the national government. Some elements of the demand side,
therefore, offset the centralizing influences emanating from the supply side, while the play of the power groups and borrowing creditworthiness support a greater degree of centralization.

If expenditures are decentralized to meet demand side considerations, this also implies that each level of government would have to be given its own distinctive revenue sources corresponding to its expenditure responsibilities. But resource endowments, both natural and financial, differ from region to region for historical reasons and, consequently, regional imbalances are a normal feature of reality. These imbalances reflect development already in the regions and may be further accentuated by the fact that opportunities for growth depend on the physical location of resources. The possible reduction in these inequalities requires that, if the ideal of revenue resources corresponding to expenditure functions is to be achieved, central pools be established to make transfers to backward regions. The aim of society is to provide a service, as well as to ensure a certain uniformity in providing such a service to the recipients. The goals of uniformity of services and reduced inequality among regions imply that revenue resources would have to be allocated to each government level in terms of its requirements and there would also have to be central pools of resources to redress the remaining imbalances. The specification of revenue resources for different levels is also needed for another reason. Nonspecification would lead to each level competing with another government at the same level for common revenue sources—a course that might lead to the erosion of each other’s tax base. These approaches may lead to firmly entrenched beggar-my-neighbor policies and to situations where some regions will be “islands of prosperity.”

From a macroeconomic management point of view, the major consideration is whether individual governments can coalesce to offer a viable framework to pursue the required policies. Or can these policies be better pursued at a central or a national level of government? Two factors seem to work against a possible coalition of regional and state levels of government. First, because resource levels are different, each region will pursue policies that are conditioned by its resource endowments. Apart from the accentuation of inequalities that will inevitably follow such pursuits, it implies that more resources will induce more expenditures and it would be difficult to limit their rate of growth, if this were desired. Second, the priorities of expenditures will also be subject to influence by the pressure groups, which, in some
cases, may be contrary to national ambitions. The management of the economy, therefore, implies a greater involvement at the national level of government. But if that level is not to become a unitary form of government, its role in macroeconomic management should be predicated on the premise that viable regional and local governments are essential in view of their dominant role in the demand group factors. A country's financial arrangements ideally should recognize the supply side economies, the multilevel decision making associated with the demand for and provision of services, and should give proper weight to distributional and economic management aims.

**FINANCIAL RELATIONSHIPS**

Financial arrangements in various industrial and developing countries reveal different combinations of the above factors and the attempts at reconciling economic compulsions and their political acceptability. Two basic types of arrangement may be distinguished—aggregative and devolutionary. In some countries, notably in the United States, federal financial arrangements were the result of the aggregation of different regions that agreed on the division of revenue resources and related expenditure responsibilities. In evolving these arrangements, there were numerous conflicts between the "centralizers" and "provincialists," which, although gradually smoothed out, left an indelible impression on the division of financial resources. In other countries financial arrangements of a federal type evolved through a process of devolution. Reflecting the legacy of the centralized administrations associated with colonial rule, these countries have financially strong central governments that dominate the regional and state governments in all financial aspects. There is a third group of countries where there are only central and local governments in which characteristically the local governments have only minor sources of revenue but major responsibilities for expenditure. In all groups of countries, however, the responsibility for macroeconomic management is with the central government. The main differences among these groups are to be found in the financial arrangements for raising revenues and expenditures.

Among the aggregative type of federations a distinction may also be made between countries where federal expenditures are substantially more than total expenditures of regional and local governments, and
countries where federal outlays are less than the regional and local outlays. In the United States, total expenditures of state and local governments are less than half of federal government expenditures. In the Federal Republic of Germany and Canada, federal expenditures are less than the combined outlays of the state and local governments. In Australia half the total expenditures are incurred by the federal government and the other half by state and local governments. Among the countries that have devolutionary financial arrangements (India, for example), half of total expenditures is incurred by the state and local governments. The significance of these amounts is to be seen more in terms of the role that state and local governments play in the overall economy.

From the central government's viewpoint, state and local expenditures are financed in three ways—by revenue sharing, grants, and loans. In Australia, Canada, India, the Federal Republic of Germany, and Nigeria, for example, there are revenues that are levied and collected by the respective levels of government. There are also levies such as income tax that are imposed and collected by federal governments and the proceeds distributed to states under specified formulas included in the constitution, through quasi-judicial committees, which arbitrate on the claims of the central and state governments, or by voluntary agreements between the central and the state authorities. These revenue-sharing arrangements provide most of the resources of state governments. Federal governments also give grants-in-aid for general or specific purposes to state and local governments. In some countries, loans are also provided by the central governments to other levels of government. In countries that only have local governments, the practice of revenue sharing is much rarer, and the general practice is for local governments to receive block and specific grants from the central governments. For this study, however, it is not necessary to discuss the revenue-sharing arrangements, as, from the point of view of budget decision making, these are determined exogenously for both central and state governments and remain relatively stable over a given period. Of greater importance are the discretionary transfers made from the central government.

2 In France local authorities receive a share of national taxation. In Denmark local authorities levy income taxes in addition to the federal income tax. These are collected by the central government and distributed to local authorities. The central government does not claim any share in the income tax levied by the local authorities.
Transfers from the central government reveal the mutual degree of dependence of the central on state and local governments for implementing programs of a national character, and the dependence of state and local governments on the central government for finances. In some countries, notably in Denmark, nearly half the total central government expenditures is for transfers to local governments. In Australia about a third of the federal government expenditure is for transfers to state governments, while in India, Korea, and the Netherlands, a fourth of the central government outlays is for local authorities. In Canada, Italy, Sweden, Sudan, Thailand, the United Kingdom, and the United States, the transfers range from 10 to 20 percent of the central or federal outlays. Data for these countries are provided in Table 27 for 1972–78. A feature of some importance is that, even in countries where the combined outlays of the state and local governments are more than the outlays of the center (Canada and the Federal Republic of Germany), or where they are about the same, the transfers from the center still have a prominent place. A similar type of relationship is also found between the state and local governments in countries that have a three-tier government structure.

The prevailing financial arrangements and the existence of systems with extensive conditional transfers illustrate that practices are far different from the picture of perfect congruence between spending responsibilities and revenue resources. The revenue resources left to the discretion of the state and local governments are often much less than their expenditure needs and are, also, often inelastic. This factor alone has contributed to the growth of financial dependence of state and local governments on central authorities. This dependence has tended to increase during periods of inflation, when lower levels of government are caught in a scissors' effect—when their revenues, being specific and inelastic, do not increase as a consequence of inflation and their expenditures, being more labor intensive, are dominated by the behavior of wage rates and the prices of private goods and services and tend to move with inflation rates.3

3In an analysis of the situation in the United States, Levin pointed out that purchases of goods and services were only 34 percent of total federal expenditures, but 56 percent of state and 96 percent of local expenditures. The service components of total direct expenditures were 40 percent federal, 90 percent state, and 96 percent local. See David J. Levin (1978), pp. 15–21.

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Table 27. Selected Countries: Transfers from Central Government to Other Levels of Government, 1972–78

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*These transfers include taxes collected in an agency capacity and all types of grants on current and capital accounts.

The inherent fiscal imbalance in the allocation of revenue resources is further compounded by the dynamics of the day-to-day working of the administrative systems of government. There have been shifts in government functions from one level to another and changes in the relative importance of government functions; these changes were not automatically matched by changes in the tax base assigned or in the tax revenues apportioned to each level. Activities of state and local governments have increased significantly, some on their initiative and some in response to the tasks faced by the central governments. Some of the new functions assumed by national governments soon found their counterparts at other levels, and some functions were shifted from the former to the latter levels. Some of the activities of local governments, even when these were conventional activities, implied higher financing needs because the costs of these local governments...
were influenced by decisions of central authorities. National wage rates were generally evolved with reference to central government resource structures and the capacity to pay. These wage rates, however, spur demands for increased wages at state and local levels and very soon these levels find themselves spending more for the same services. The above factors tend to increase state and local financial responsibilities without providing a corresponding increase in their revenue resources. In turn, these increases lead to more transfers from the central government. The growth in transfers also reflects the more serious pursuit by central governments of equalization goals and the changes in their financial status. Central governments with more elastic revenues have been obliged to transfer some of their inflation gains and gains from the real growth in the economy to the state and local levels. In sum, the alterations in size and the real developments in the economy and government functions altered the relationships between central and state governments. The manifestation of these changes is found in the magnitude of the intergovernmental fiscal transfers. Independent country studies suggest that the fiscal transfers from central governments have grown both in relation to GNP and to central revenues and expenditures. The administrative nature of these transfers, however, has undergone some changes, as in some countries the transfers were mostly for special purposes or were conditional as a result of central initiatives or as part of common financing of development plans. In some countries, however, the conditional grants play a minor role and the transfers for the most part are in the form of bulk grants. The growth of fiscal imbalance and the financial dependence of state and local governments on central government caused changes in the approaches to budgetary decision making.

**APPROACHES TO BUDGETARY DECISION MAKING**

The nature of the financial relationships generates different value systems both at the giving and receiving ends. The differences reflect the structural fiscal imbalance between the central and regional and state governments and may be analyzed in terms of the approaches of

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4For example, for India see A. Premchand (1966b), pp. 176-204; for Canada, see Richard M. Bird (1979), pp. 56-58.
the central government and those of the regional and local governments. The interests of the central government arise from its responsibility for macroeconomic management and as an agency providing a major part of the resources of the state and local governments. From the point of view of macroeconomic management, the central level seeks a voice in the determination of total expenditures of other levels. It has, however, no independent voice as long as the lower levels of government have attained a balance between their expenditure requirements and revenue resources. However, as this balance is rarely attained from within their own means, the provision of funds permits an opportunity, at least in theory, for the central government to influence the size of expenditures at the lower levels. The relationship in this respect is different from the government’s link with its own enterprises. All or most of the capital for enterprises is provided by the government and ownership provides them with the rights of management and related controls. No such rights exist in their operations with state and local governments, for they are endowed with a major degree of coercive power for the levy and collection of taxes and freedom of operations in incurring expenditures. The option available to the central government for influencing the operations of other levels of government is at best marginal and has no legal enforceability about it. The central government may withdraw its resources or reduce them but neither of these approaches may have the desired effect as long as other levels of government may substitute their own resources to finance their chosen level of operations. This is not to imply, however, that the central government should choose a course of inaction. On the contrary, it suggests that macroeconomic objectives are better achieved not by unilateral action, but by coordinated activity. As a provider of grants, central governments play a more active role in ensuring allocative efficiency. Provision of conditional or specific grants implies much more attention to the detailed allocation of resources. Also, the central government as a grantor is entitled to require, as it is paying for benefits received, that its funds be used efficiently and to exercise controls over the grantee’s operations.

5 It is because of this concern for allocative efficiency that governments prefer transferring resources by grants rather than by revenue sharing. The latter is done with reference to selected formulas that are uniform in their application. Grants are discretionary and can be adjusted to reflect the changing objectives of the grantor.
of all supported programs. These program controls are functional and administrative in nature and have less relevance for macroeconomic management.

The achievement of macroeconomic management objectives assumes that the implications of such objectives are clear to the grantors and that such objectives have, in some degree, been formalized in operational terms. Specifically, this requires that the objectives be translated in terms of increased or reduced programs for the central spending departments. At a higher level, a decision has to be made whether such approaches will be appropriate to maintain the balance between central and regional governments. Experience indicates that neither is given due consideration. The track record for central governments in anticipating the requirements of macroeconomic management and the articulation of related policies is not an enviable one. It appears that the lower levels of government receive conflicting and confusing signals. On one hand, they are urged by central agencies to increase their expenditures even when the central administrative agencies are not yet ready with programs to use such funds. On the other hand, they may urge the state and local authorities to limit their total expenditure, while, at the same time, individual departments demand they give greater priority to particular services and to spend more. These conflicts, which are frequently pointed out to the embarrassment of central governments, reveal the extent to which further progress has to be made to develop a more consistent approach toward the lower levels of government. This type of problem does not, however, occur in the financial relationships between state and local governments. Unlike central governments, states are more circumscribed by financial than by economic constraints and their concerns are more with allocation than with stabilization aspects.

The effects of financial imbalance on the approaches of state and local governments are far more significant and extensive and ramify their whole budgetary process. First, the degree of financial dependence on the center is directly indicative of the pivotal role that transfers play in the financial and budgetary plans of the government. The constraint is felt both at the program and aggregate level. Expenditure

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6 For an illustration of this type of experience in the United Kingdom, see Local Government Finance (1976a), p. 241.
priorities are determined at the granting level, which, depending on the level of transfers, may even suggest that the budgets of the lower levels of government are formulated by the grantor rather than by the recipient. Some suggest that the constraint may have an unfortunate impact, as greater central control may weaken the sense of local responsibility.\(^7\) This is an arguable point.

Experience in the United States and India suggests that greater dependence on central government, far from lessening the responsibility, has engendered a competitive atmosphere for obtaining more funds from the center. The acquisition of grants has become a political status symbol and has gained considerable visibility. States and local governments vie with each other to increase their share of grants, and grantsmanship, defined as the capacity to obtain more resources, has become an art form. More energy is devoted to obtaining grants as they tend to become an easier option than raising resources. In India, where central grants are given to lessen backwardness, a vested interest in backwardness has appeared and each state provides data to claim that it is more backward than others. Although similar resource constraints apply to public enterprises as well, the approaches of the state and local governments differ from them. Public enterprises do not generally compete among themselves in the same sector and, thus, each one is financed from funds set apart for sectors. The states, however, compete for a given sum and are engaged in playing a zero-sum game, for any gain to one state implies a reduced allocation to the others. These approaches are also applicable to revenue-sharing arrangements. The competition is no less even when financial adjustments are made through quasi-judicial agencies, except that the arena shifts from the government to those agencies.

Use of the grants at the receiving end requires preplanning for the use and installation of systems and procedures that would ensure their quick utilization. The experience of the United States shows that special budgetary procedures were used for grants and these were

shown separately in the budget to provide the much needed visibility. Also, several of the normal procedures for budgetary allocations were scrapped and grants were obtained through a highly politicized process. A similar experience is also found in India, although in using the grant proceeds no distinction was made between states' own revenues and other grants.

**Fiscal Management**

The overall responsibility of central governments for economic coordination and fiscal management can be translated into material action programs only when relevant provisions of funds or legislation are included in the budgets of the state and local governments. Such action programs need to be examined in terms of mobilization of revenue resources, expenditure management, and government borrowing at the respective levels of central, state, and local governments. In analyzing these, the policy concerns of governments in developing countries for raising more revenues and for devoting them to growth, as well as the policy objectives of short-term economic management that dominate the approaches of the industrial countries, need to be kept in mind.

**Revenue Management**

Revenue planning in the context of mobilization of resources needed for financing development plans is carried out in developing countries by the planning agencies attached to the central government. These agencies estimate the resources needed for the plans and the resources that would become available from existing and additional avenues. These estimates are shown aggregatively and participating governments are free to choose their own methods and also to determine the timing of the measures. The aggregate estimates are frequently revised, together with revisions of expenditure estimates of the plan. This type of revenue planning has numerous weaknesses, some of which have been noted in Chapter 6. The concern here is with the

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problems of intergovernmental fiscal management that arise because of the existing approaches to revenue planning.

Ideally, revenue planning should imply a detailed consideration of the fiscal capacity and potential of each state in terms of its economic endowments. Determination of these two aspects is, admittedly, difficult even when viewed purely as an economic task. When political aspects are added, which is inevitable, this task becomes even more intractable. Detailed revenue planning, however, is not undertaken, as is evident in India’s experience with development plans. Indications of desirable magnitudes and lack of revenue planning have, therefore, contributed to avoidable problems. First, the required resources were not always raised and greater reliance was placed on the easier option of borrowing from the public or financial institutions. Second, the pattern of resource mobilization suggests that indirect taxes such as sales taxes were heavily used, which in some measure contributed to cost-push inflation and reduced available incentives for some types of industries. The revision of rates was far from uniform and there was unhealthy competition to attract capital. In the process the tax base of certain categories of taxes was eroded. Also, there were conflicts between the states’ views on their own needs and instruments and the views of the center. States tended to levy duties on their major products (such as tea or oil), which was in conflict with national policy objectives of export promotion or development of domestic infrastructure. Such conflicts, unlike those within a government, tend to be public and, before long, the interest groups join in the debate and the eventual compromises become less efficient from an economic point of view. The problems do not entirely rest with just the regional and state governments. The approaches of the center have, on occasion, added to the already tense situation. States contend that the central government generally chooses to raise revenues by taxes, the proceeds of which accrued only to the center, by surcharges, or by nondivisible revenue sources, so that no part of such resources can be shared by states. As for timing, it appears that the measures of the state governments were less responsive to income increases, as their tax base was limited. Even when taxes on consumption could be used to restrict spending,

9The importance of sales taxes in the overall revenue structure has grown considerably during recent years and, together with union excises, contribute nearly one third of the total revenue in India.

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measures were often delayed and, being far from uniform, only contributed to a geographical shifting of consumption from one state to another.

The practices of the industrial countries reveal a different picture. In the United Kingdom, although there is no revenue-sharing arrangement, a grant element is partly determined in terms of a prescribed National Standard Ratable Value and the actual ratable value per capita in each county. The difference between national standards and the estimated ratable value per capita constitutes the basis for estimating the grant. The local authorities, it is assumed, will not be interested in raising more resources than is indicated by the ratable value. This assumption, however, does not always obtain and when the compulsions of spending become stronger, local authorities may exceed the norms and raise revenues, as has been true during the early part of this decade. Such increases could adversely affect incentives and, as the incidence of rates is mainly on local businesses, they could be particularly harmful during recessions. One way in which the local authorities could be dissuaded from taking this action is by a mechanism that would enable local governments to keep the proceeds of the rates only insofar as increases are within the prescribed standards, and to siphon off the increases beyond the norm to the national treasury. However, no such regulatory mechanisms exist.

In the Federal Republic of Germany two thirds of total tax revenue is divisible and this pool includes the principal sources of revenue, such as the wages tax, turnover taxes, income and corporation taxes, and the municipal trade tax. The remaining less productive taxes are allocated in full either to the Federation (mainly consumption taxes) or to the Laender and local authorities. To minimize tax distortions, legislation for a large part of the taxes (excluding property and transaction taxes, which are administered by the Laender governments) is vested exclusively at federal level. Germany, to that extent, represents a deep fiscal imbalance, in that a major part of the total expenditures are incurred by the Laender and local governments but are financed by taxes that are levied, regulated, and controlled at federal levels. In the United States some allocations are made to the lower levels of government from federal tax revenue, but these are small in comparison with the transfers. Resource mobilization is made by the respective governments in their spheres and there is little coordination between them.
Canada has a far more complex system, but the two main elements insofar as revenues are concerned relate, first, to the collection of income taxes in all but one of the provinces and corporation income taxes in all but two of the provinces, and second and to a lesser degree, to the revenue equalization system. The income-tax sharing arrangements have had some major changes since World War II and now provincial taxes are expressed as a percentage of federal income taxes and are collected by the Federal Government. Income and corporation taxes contribute nearly 60 percent of total taxes, and the legislative power controlling them provides enough authority for the Federal Government in Canada. Cash transfers under the revenue equalization system involve a certain amount of revenue planning at a national level, as these transfers attempt to bring the revenues of the recipient states to a level that they would have received if the national average tax rate had been levied on a share of the national tax base equal to the states' share of total population.

In the Netherlands municipalities receive a share of certain national taxes and also the entire proceeds of real estate tax. Among the countries shown in Table 27, in Denmark, Korea, and Sudan, the local authorities only have some minor sources of revenue and, therefore, little or no capacity to pursue revenue mobilization measures that may be contrary to the aims of national fiscal policy. In summary, therefore, arrangements that involve greater centralization of decision making for levying and collecting taxes may prove more conducive for stabilization purposes; where the state or local governments have independent sources of revenue, there is considerable potential for the pursuit of disparate tax policies. Some of these could, however, be mitigated by specific arrangements for ensuring coordination but their success is predicated on the quality of more detailed revenue planning at all levels.

FEATURES OF GRANTS: EXPENDITURE MANAGEMENT

Expenditure transfers from the central government are varied and give rise to several economic and administrative issues. By the nature of the instrument, grants may be divided into two broad types—general or unconditional grants and categorical or conditional grants. Within these two groups, however, there are variations on a common theme, all of which are illustrated in Table 28. General grants are
Table 28. Features of Grants

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1These grants tended to be open ended up to 1980 when they were made more definitive.
2These grants are generally additive. When the local authorities wish to provide a service at a higher level they can do so by mobilizing their own revenues. To that extent these are substitutive.
3Substitutability or additivity is indeterminate in these instances.
primarily given for covering the fiscal needs of the recipient governments and, depending on the requirements, may partly be used for equalization purposes. Three types of grants shown in Table 28 and covered under this category are the grants-in-aid for general purposes given in India primarily to meet the deficits on the current account of the state budgets, the bulk grants that have been a feature of the United States and Canada, and the rate support grants in the United Kingdom. The general grants in India are determined for each state on the basis of its claims for the next five-year period; these claims are scrupulously examined in terms of objective criteria by an independent commission whose recommendations are generally binding on the governments. Similar procedures have existed for more than five decades in Australia, where a Commonwealth Grants Commission determines the magnitude of transfers to the claimant states. The grants given in Australia have a notional equalization basis as the standards of selected services are taken into account. In the Indian context, equalization is sought through the development plans, the patterns of their financing, and central investment rather than through general grants-in-aid. Bulk grants in the United States are determined with reference to an apportionment formula that takes into account population and the financial ability of the recipient state.

A more detailed procedure is followed for the determination of the rate support grant in the United Kingdom. These grants, which play a considerable role in the system of local finance, consist of elements that are intended for financial compensation as well as for meeting fiscal needs, and, therefore, cannot be classified precisely. The two major elements are a domestic rate relief grant and a block grant. The former is relatively simple in its design and is payable to all local agencies to offset the requirement for them to reduce the rate levied on dwellings by an amount determined by the central government. It is based on the principle of financial compensation. The objective of the block grant, on the other hand, is to allocate sufficient monies to every local authority in order to provide similar standards of service for a similar rate of the pound sterling. The amount of the grant is determined by a two-way process. First, the expenditure needs of each county are assessed by relating spending to average costs of services, with adjustments to take account of indicators having a direct effect on the cost of the services, such as scattered population or other factors. The total expenditure thus arrived at is then related to the amount that a
local authority could raise through ratable values applicable in their areas. The difference between the two is given as a block grant that is now subject to the overall cash limits of the central government.\textsuperscript{10}

General grants are specified either in the original legislation or in the annual budget appropriations and are definitive in adhering to these limits. To the extent that they are given primarily to compensate for fiscal deficits or even for equalization, resources becoming available to the lower level of government constitute net additions. The question is, however, if the main purpose is to ease the financial burden of the state and local governments, whether the same purpose could not be better served through revenue sharing, which may be administratively more simple and less expensive. The limitation of revenue sharing is that the principles of devolution of federally collected tax revenues have a uniform applicability to all the states and cannot be distinguished by the fiscal capacity of the state. Principles such as population base and origin of taxes take into account the fiscal capacity of the state, but once the principles and percentage shares of divisible pools are established they are applied to all states on the same basis. In this event, states that have fiscal surpluses may add to them, while, at the other end of the spectrum, there may be states that will still be in deficit even after receipt of their share of divisible central taxes. Grants, on the other hand, can be tailored to the fiscal capacity of the state and are useful in bringing some states to the national level.

Conditional or categorical transfers are more varied and each instrument is the result of a relatively complex piece of legislation aimed at a particular set of objectives. At an economic level and viewing the problem in its simplest terms, grants for specific purposes reflect the relative prosperity (or the severity of fiscal imbalance) of the grantor, and the presumption that the use of grants will benefit recipient governments and, in due course, will lead to economic development. Conditional transfers are, therefore, viewed as instruments for promoting a specific local economic activity, to demonstrate the usefulness of a particular social or economic approach, or, more often, to implement some tasks in which the grantor has a special interest. Reflecting these aims, grants are made conditional and the specific purposes or the groups that are to be served are stated at the

\textsuperscript{10}For a more detailed account of prevailing and past systems of Rate Support Grants, see United Kingdom, Local Government Finance (1981).
outset. Their fiscal impact is dependent on the nature of the conditional transfer and may not represent net additions to resources for the programmed objective. This may be true when federal grants contribute only a fraction of the state or local resources utilized for the same objectives. It is likely in such situations that central funds are simply substituted for state and local outlays—funds that would otherwise have been used for the same purposes. By the same token, the conditional transfers may not stimulate any economic activity and their very basic objective may be rendered questionable. In some cases, however, these grants are additive in the short run, but it is somewhat indeterminate whether, by making the lower levels of government more dependent on the central authorities, their own capability for raising extra revenues is being underrated. Evidence in this respect is not conclusive and the dilemma between promoting activities that are considered to be additive and those that become substitutive has always influenced the features of the grant system.

The simplest form of a conditional transfer is the grants-in-aid (variously described in different systems) given for agency functions performed by lower levels of government for the federal government. The nature and purpose of the work is specified and the actual costs incurred are reimbursed by the grantor. By their nature they are open ended and technically provide no inducement for state and local governments to economize within their administrations. Although these approaches are quite plausible, the areas for which such grants are provided are few, the amounts involved small, and, on the whole, any damage is likely to be negligible.

A second form of conditional transfer is the matching grant system, which involves cost sharing by the grantor and the grantee and the respective shares are determined with reference to specific formulas that can vary with the fiscal capacity of the recipient level of government. Conceptually, matching grants have a number of positive features. To the extent that the cost is shared, the amount received as a grant represents an additional resource and, to that extent, provides an incentive for the grantee to participate actively and

\[ \text{In the United States the matching formulas have an equalization objective and are, therefore, varied for each state in terms of its fiscal capacity. In India, however, when the matching grant system prevailed, the principles of cost sharing did not distinguish the capacities of the recipients.} \]
to contain aggregate expenditures within specified limits. It also places considerable emphasis on the complementarity between the center, states, and local governments and has an innate capacity to foster collective working toward common goals. As a logical extension of this approach, matching grants are viewed as an ideal instrument to minimize the overlapping and duplication of effort that is inherent in the division of responsibilities among the various levels of government. These advantages, however, appear to have been more than offset by the problems associated with the matching grant system. The Indian experience suggests that problems were faced in the resource management of the matching grant system, as the cash releases by central government were made only toward the end of the year and, meanwhile, states had to borrow extensively to maintain the rate of program implementation. For this reason alone, this system was abandoned in India. Elsewhere, the matching grant system became open ended and, where initial monetary determinations were made, these were soon out of date because of rapidly accelerating inflation. In Denmark the Government opined that the system of matching grants did not give it enough control, as the system was open ended and, therefore, it was replaced by a system of block grants. The system, however, continues in the United States, where the problem primarily relates to the immense complexity of sharing formulas and the extensive conditionality associated with them. During recent years, however, there has been a consolidation of the different matching grants. The success of the matching system depends, to a large extent, on the ability to prevent any excessive spillovers into the central budget and to ensure that the grants are indeed spent for the purposes for which they were intended.

A most common instrument, however, is the conditional grant that now dominates the fiscal transfers in some countries shown in Table 27. Similar conditional transfers\(^1\) are also made from state to local governments. Frequently, the formulas adopted for conditional grants provide weight for an equalization objective and can be varied inversely with the fiscal capacity of the state. Their effectiveness in this regard cannot, however, be assessed without consideration of the working of other transfers. The greater spread of this instrument also implies that, to the extent conditions are unilaterally attached by the grantor, there

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1\(^{1}\)In India such conditional transfers also have a loan element.
is, in effect, a shift of decision making to the federal level. The receiving levels may have no option but to take them, even when the services, which are planned on a national level, have little relevance to their needs. This kind of distortion could be minimized, however, when the content of the program is also varied to meet the specific requirements of the recipient.

BUDGETING FOR GRANTS

Federal transfers have gained the reputation of being unpredictable and as having been used, more or less, as an instant aspirin to assuage the feelings of one state and the claims of another and to promote a specific activity in a third. They are seen as being used to heal politically based hypochondriac claims. This image can be reduced and transfers can function meaningfully only when their goals are specified, the forms of grants are chosen with care, and resources are estimated on the basis of objective criteria. Similar care is also needed for the use, control, and evaluation of the monies provided. These factors clearly underscore the need for budgetary planning and management.

Budget planning practices reveal three ways to coordinate expenditure plans between the central and state or local governments. The first refers to a formal and integrated framework in which a composite view is taken on national requirements. In the United Kingdom and Denmark, public expenditure requirements of local governments are prepared annually on a multiyear basis and are revised each year for successive years. Local expenditures are forecast on the basis of central guidelines and are included in public expenditure forecasts by the central government. The estimates included in the forecasts have no legality or enforceability and no sanctions follow if the local authorities fail to conform to the indicated expenditure pattern. A dialogue, however, ensues whenever there are sizable discrepancies between the actual budgets of local authorities and earlier estimates included in the multiyear budgets. The second way refers to a system where multiyear budgets are prepared by the federal, state, and local authorities in terms of mutually agreed economic objectives and are coordinated with each other rather than being formally included in central government

13This has been true for assistance for the malaria eradication program in India. Similar instances are found in other countries.
financial plans for the future. The German Economic Stability and Growth Law makes the three levels of government observe the requirements of overall economic equilibrium and budget on the basis of the five-year financial plans. To implement this, a financial planning council has been formed with representatives for each government level to make recommendations for the coordination of financial planning at federal, state, and local levels. Actual plans are drawn up independently and coordination is voluntary.\(^\text{14}\) The third way refers to a less formal and more aggregative type of financial planning where the role of the central government is limited to a broad review of the plan component of expenditures and to a more detailed scrutiny of the projects and programs financed by it. This practice is observed in India, where the current budgets of state governments are reviewed by an independent commission, while the Planning Commission examines the development plans of the states to ensure consistency and feasibility. A common thread through all the systems, however, is the continuing dialogue among governments, which helps to understand the others’ intentions and the extent to which finances are likely to flow from the central government to the states.

**Budgetary Controls**

The relationship between the central, state, or local governments is a delicate one and that alone is an adequate reason for evolving control techniques that are different from those adopted toward the spending agencies and public enterprises. Intergovernmental control systems are rendered even more vulnerable due to two different problems: (a) problems associated with achieving objectives through activities once or twice removed from the decision maker and (b) problems of administering the process within severe time constraints and under constant political pressures. Both these factors have influenced the design of the grant systems, as well as the features of the formal controls exercised.\(^\text{15}\) Grants such as the matching type have been

\(^{14}\)This was not without problems, however, when financial plans were initially organized in the early 1970s; one laender government did not present any financial plan at all.

\(^{15}\)It has been argued, however, that these are at best economic rationalizations of what is, in effect, a formal legalistic process reflecting the superior money power, as well as national concerns, of the central government.

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evolved to stimulate local enthusiasm and to create a participatory role for local authorities. This offers only limited opportunities to ensure the fulfillment of the program objectives for which finances have been provided and which are, therefore, supplemented by different control mechanisms. These control mechanisms are generally more passive and rely, to a very great extent, on moderating the releases of cash and on obtaining reports about their use. Controls to release funds provide safeguards against their immobilization but are not positive in ensuring their implementation or in changing the course of action, if necessary. The usefulness of the reports is limited to information and even in this regard its success is dependent on the compliance shown by other levels of government. On the whole, controls exercised by the central government are indirect and rely more on the complementary role of other governments in the hope that what is not accountable to them will become accountable to the respective legislatures or county councils.\(^{16}\) This is evident from the commonly observed phenomenon that grants are rarely terminated even when they are inefficiently used. The use of control mechanisms is clearly restrained by the fear that their repercussions will extend beyond the financial sphere to the whole of the community. Where joint financing is involved (as in the Federal Republic of Germany) or where loans are raised jointly (as in the United Kingdom), controls can, in theory, be powerful, for they determine, within narrow limits, the annual amounts that local authorities may allot for capital formation purposes. These controls, too, are financial in nature and depend on hopes that the local authorities will ensure their proper use.\(^{17}\)

### Issues in Grant Management

The operational aspects of grant management have raised many issues, some technical, some fundamental. To consider the former first, the recipient governments complain that the formulas to

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\(^{16}\)This aspect is frequently disregarded by the federal legislatures and they demand more controls on the states' use of the transfers.

\(^{17}\)Such isolated control of capital expenditure that is partial in its application can be unsatisfactory and can have distorting effects on resource allocation. For an elucidation of this point in the context of the United Kingdom, see United Kingdom, *Report of the Royal Commission on Local Government in England, 1966–1969*, (1969b), p. 242.
determine grants are not updated frequently enough, with the consequence that some of them are adversely affected. This view is based on solid experience and underlines the fact that no formula, however scientific, is permanent and needs to be revised to reflect changing requirements. More important, the working of some of the formulas may be biased toward increasing expenditure and, therefore, need continual assessment. Second, negotiations for obtaining grants take too long, lack finality, and, therefore, generate uncertainty on budgetary outcomes. Third, it is suggested that the formulation of mandatory yardsticks, planning and programming procedures, and guidance circulars and instruction manuals impose many restrictions on the use of funds, and these standards are uniformly applied without considering the additional cost that their compliance will involve for some levels of government. Frequently, the insistence on these standards is seen as an excuse to intervene in the affairs of the lower levels of government. Experience in many countries shows that the controlling zeal of the central administrative departments to regulate may have the same effect on the recipient government as the government regulation of business. While some of these criticisms are exaggerated, there is also a substantial undercurrent pointing up the necessity for simpler administrative procedures.

Viewed from the grantor’s point of view, a common difficulty is that all financial problems appear to finally land on the grantor, for the reason that there is no effective control to ensure that the lower levels of government adhere to the original estimates or the grant. Consequently, grants that are open ended, such as the central assistance provided for plan purposes in India or the rate support grant system in the United Kingdom prior to 1980, tend to increase expenditures at the center. In both countries the state and local governments had every incentive to spend more and their increased requirements had to be finally met, by loans in India and by additional grants in the United Kingdom. To the extent that transfers of this type dominated the budget, in effect it meant that the budgetary outcome of the central government was dependent on the actions of other levels of government.

For example, the system of Rate Support Grants in the United Kingdom relied on the statistical technique known as stepwise multiple regression analysis, which led, among other things, to excessive spending by groups of authorities with similar characteristics, leading to further increases in the amount of their grants.
The more fundamental problem of the management of grants, as seen from the center’s view as well as from the view of the receiving end, relates to the stability in the size of the grant. It is the contention of the lower level governments that their short- and medium-term expenditures are determined by the level of the grants provided by the central governments, and that any changes in these levels, once indicated, will have grave repercussions on the quality of the services provided. This viewpoint is not by any means a unique one; indeed, as has been repeatedly stated earlier, this is a common refrain of spending departments and public enterprises. This view is only natural, for each government level and agency is concerned with its own financial needs and is less mindful of the aggregate impact of such demands on the economy. Unlike grievances of the agencies, however, the demands of state and local governments have greater political overtones. The attitudes of these authorities undergo some changes depending on the economic climate. When the economy is growing and prosperity is being experienced by all levels of government, albeit in differing degrees, the rising tide lifts all boats. In such a context, the concerns of state and local governments are directed more toward the distribution by the central pool than toward the absolute size of the grants received by them. When the economy is stagnating or declining, their endeavors are directed more toward the protection of the size of the grant they had been receiving earlier. When the economy is stagnating and inflation is accelerating, then protective endeavors become even stronger. Some elements of the federal transfers, particularly statutory ones, are generally insulated against annual changes. Specific and conditional grants, however, are dependent not only on the broad policy intentions of the granting government but also on the economic and financial constraints of that level and they are, therefore, liable to vary. If state and local governments are to be protected from the influences of those constraints, the burden of adjustment should shift to the grantor. Such a course may not be possible, even if the argument is conceded in principle, for the reason that the transfers may be the dominant feature of the federal budget and, once excluded, there would be little left for making the adjustments. The U.K. Layfield Committee suggested a variation on this theme; its view was that a limit should be placed on the grant payable so that the local authorities could realize the extent to which they could draw on national resources. This approach has, however, the same limitation as noted.
above, for the limits would become immutable, thus preventing further adjustment. It is arguable whether more operational freedom be provided for the central authorities in view of their responsibility for fiscal management or for the local authority in view of their proximity to the public. In any event, the choice cannot be made by economic factors alone. It is apparent that central governments consider necessary changes in the size of new transfers, while state and local authorities tend to believe all such exercises to be metaphors for the search of new control mechanisms.

BORROWING

The magnitude of borrowing by state and local authorities is important not only as a barometer of the financial condition but also as a factor in macroeconomic management. In the Federal Republic of Germany, for example, borrowing by the local authorities, which was responsible for about two thirds of public investment, was a matter of grave concern and the 1969 finance reform was directed at establishing improved procedures for borrowing. In India unplanned borrowing by the state governments through extensive overdrafts from the Reserve Bank of India has been a continuing source of fiscal instability for more than two decades. The institutional arrangements for borrowing by state and local governments reveal two approaches—total freedom, on the one hand, and coordinated and centrally controlled programs, on the other.

In the United States, states are prohibited from borrowing to cover operating expenses. They may, however, borrow for capital expenditures—an avenue that was exploited more by them than by the Federal Government, as was evident during the 20-year period from 1959. During this time, the state and local debt grew at an average annual rate of about 8 percent, while the federal debt grew at an average of a little more than 5 percent. In France the public works programs of local authorities are financed by loans from the Caisse des Dépôts et Consignations, which manages the funds from the national chains of savings banks. They may also borrow from other quasi-public credit institutions and under strict conditions from commercial banks or the market. More important, the Prefect of each administrative zone is expected to exercise controls to prevent local authorities from incurring
budgetary deficits.\(^{19}\) In the Federal Republic of Germany borrowing by the states and local authorities (as well as by the Federal Government) has to be approved and the timing of issues coordinated by the Financial Loans Committee (represented by the three levels of government) and the central bank. In the Netherlands the local governments can borrow up to a specified proportion of their budget, but the central government reserves the right to impose controls if they are considered essential. The capital expenditure of the municipalities, except housing, is funded by loans from the Bank of the Netherlands Municipalities. In Denmark local authorities can borrow within limits set by the central government. In Australia the combined borrowing of the Commonwealth and state governments is decided by a loans committee (represented by the two levels), which also agrees on the apportionment of the proceeds. In India the states are technically empowered to borrow from the market, but the amount of borrowing and the timing of issues are determined in consultation with the central bank and the central government. The National Loans Fund in the United Kingdom is responsible for raising loans both for the central and local governments.

Independent borrowing by the states and local governments has both positive and negative aspects. In a positive way, borrowing encourages the states to cultivate the markets and to develop them. In theory, it could also generate greater financial responsibility. There is, however, no guarantee that such responsibility will always be used wisely and experience suggests that excessive reliance on borrowing, which anyway is considered as an acceptable expedient and a preferred political alternative to taxation, may promote undesirable competition for loanable funds within the public realm and increase interest rates. This, in turn, may work against the stabilization objectives of government. More important, states that are economically less developed and have no capital markets may find it difficult to have their loans contributed. These negative aspects have dominated the government outlook and it is for these reasons that efforts are made for coordination of debt issues. Centralized borrowing, which represents a sophisticated form of institutionalized coordination is considered appropriate for stabilization purposes, for it enables the central government to keep a firm hand on the tiller. The distribution of the

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\(^{19}\)This is likely to change, in view of the recent proposals for decentralization.
amounts so borrowed, however, becomes a political issue and, as experience suggests, could even be subject to threats by some states of separation from the federation. When the debate shifts to the political level, the relatively technical considerations of economic stabilization pursued by the fiscal troglodytes receive short shrift.

Another source of borrowing by the state and local governments is from the central government itself. In some countries, for example, France, Denmark, and the United States, there is no lending by the central government to the state and local authorities. Such loans are, however, quite substantial in Australia, Canada, and the United Kingdom, and represent loans organized by the central governments on a central basis for purposes such as housing and hospitals. In developing countries loans arise in the context of on-lending funds received from aid agencies from abroad. Central lending in India, however, is different and essentially reflects common financial resources organized by the central government for financing the development plans. The transfer of resources, therefore, is by both loans and grants. During the first four plan periods such loans were substantial and a stage was reached when the repayments by the states was largely arranged by fresh borrowing from the center. Thus, amortization became a technical accounting matter rather than a fiscal issue. This situation was the result of policies of providing funds without first determining the relative shares of loan and grant elements and, in some measure, was due to a lack of inquiry into the productivity and repayment capacities of the projects and programs financed by loans. The Indian states viewed these loans as an easier option for financing their own budget deficits. They also resorted to sizable overdrafts from the central bank, which, in turn, contributed to considerable credit expansion. The Indian authorities considered three options for avoiding resort to inflationary financing by the states. One option that was utilized from the beginning of the planning period was to consider the state budgets at a preliminary stage and agree on the size of the budgetary deficits. This practice, which still continues, has not proved of much avail, as the actual budgets and their outcomes have usually differed from the agreed ones. A second course available to the government was to establish a separate bank from which states could borrow for financing projects. This was expected to ensure the financing of only those projects that are economically viable and, therefore, to fulfill the financial obligations.
This step was not considered appropriate, as it effectively converted an intergovernmental relationship into a commercial transaction between a bank and its clients. There was also apprehension that a part of the planning process itself would be shifted from government to the banks. The third option was to place restrictions on overdraft facilities—an approach that was adopted by the Government and was sought to be implemented many times but to date with negligible effect.20

Central borrowing, however, raises an important question: when and in what circumstances should there be lending from the center to the state and local authorities? Lending by the center from its own resources implies that it has more resources than are needed for its purposes. If such a presumption is correct, it may be more appropriate to reallocate the prosperity of the center so that the severity of the fiscal imbalance at the lower levels of government can be reduced. This, however, is not true, for the loans given to the states represent the borrowed resources of the central government. It may then be argued that if the resources transferred to lower levels of government are from public borrowing, a more appropriate course may be to make the states direct partners in borrowing from the public, instead of providing the central government with more control, by channeling the loan proceeds through its budget. This viewpoint gains added strength where states are borrowing from the public anyway.

**Problem-Solving Approaches**

The preceding analysis indicates that anything approaching uniformity cannot always be attained in a diversified universe. The responsibilities for macroeconomic management are, however, as much facts of life as the Atlantic Ocean is a fact. The key issue is how can these responsibilities be fulfilled with minimum distortions while being consistent with the division of responsibilities envisaged in the constitutions? In answering this question, it should be remembered that a system of well-distributed responsibility by itself will not promote stabilization but will have to be preceded by an appropriate

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20The measures were partly negated by lags in the reporting systems. Overdrafts were only known long after they occurred, and the central government had to regularize them by converting them into loans.
set of policies. It is, therefore, assumed here that such policies are pursued and that the issue is one of ensuring improved liaison among the three levels of government.

The first solution, which is autosuggestive in the light of the problems enumerated earlier, is that there should be greater responsibility and a larger role for the center. It may be argued that such a role would only be appropriate given that the center is more like a runner in a relay race who has to do not only his share but is also obliged to compensate for the delays or slowness of the other members of the team. The greater power for the center, as envisaged in this view, is not through additional powers for the levy and collection of taxes but by an improved managerial role. The enlarged function could involve detailed scrutiny of the budgets of other government levels and specification of the extent to which resources are to be mobilized, funds to be allocated, and instruments and size of the annual borrowing delineated. The lower levels of government would formulate these budgets and submit the relevant information to the federal government, but their actual operations would be subject to approval at the higher level. In order to ensure that the implementation of the budget is in conformity with the original estimates, the central government could also be empowered to issue directions to terminate its transfers and selected expenditures of the state and local governments. Such dominant central responsibility, even if desirable for macroeconomic management, has obvious limitations. If implemented, it will in effect be a vertical integration resembling the operations of a holding company and, viewed from the states and local authorities point of view, is a road to serfdom. Even at an operational level, it may clearly be a very formidable job for the central government to function, in effect, as the budget agency for the whole country.

An alternative is to provide greater responsibility for state and local governments by making them responsible for their expenditures by raising the revenues needed to finance these expenditures. Their accountability would be to their own legislatures or to elected councils. The fiscal decentralization implicit in this approach is that there would be greater fiscal balance between revenues and expenditures at the local level and the role of federal transfers would be minimal. This view, in a way, reverses financial trends and ends the fiscal dependence of the states on the center. It is, however, arguable
whether such decentralization would help macroeconomic stabilization if responsibility continues to be with the center. Also, decentralization will depend on the skill, discipline, and administrative competence of the state governments and there will be the usual quota of anomalies and errors that inevitably accompany decentralization. Moreover, considering that the problems experienced are also due partly to the decentralization already existing, it could be argued that they will be further aggravated by the proposed broadening of local responsibility.

Both the above approaches represent extreme positions and essentially reflect the subjective preferences of those seeking greater or lesser centralization. It is more appropriate that improvements are envisaged in the context of the available institutional framework. The primary problem in the relationships between central and state governments and in achieving appropriate intergovernmental fiscal management is one of articulating policy and communicating it to the members of the team. While there is some difficulty in formulating correct policies, there is also no denying management is part of the problem. A better understanding among the governments about their respective requirements is an obvious necessity. State and local governments must have a better appreciation of their role in the national economic management. Controls, however strong, cannot work in an atmosphere that is characterized by lack of trust. If central agencies persist with their controls, they will only end up encouraging resort to escape mechanisms. Trust is subjective but there is a possibility of increasing its usefulness when there is improved understanding. Experience of industrial and developing countries suggests that this could be improved through consultation, which is recognized as a two-way street.

Such consultations are formally institutionalized in some countries such as in Australia, the Federal Republic of Germany, and India, while in some countries, for example, in Denmark, gentlemen’s agreements have played an important role.\footnote{This seems to have been successful in Denmark for two reasons. First, there is an implicit threat that legislative measures will be taken by the center if agreements are violated by local governments, and second, the agreements have provided an insurance for local politicians for implementing them by passing on the responsibility to the central government. The second feature, however, does not appear to yield the same results elsewhere and, in any event, it is only likely to be successful in the short run.} The previously described
problems have their origin, not in the lack of consultation, but in the way in which the consultation machinery operated. In the long run institutional factors cannot compensate for lack of policies. Solutions for intergovernmental fiscal management may, therefore, have to be found in the accommodation, cooperation, empiricism, and balance shown by the partners.


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