CHAPTER 13

Government Budget and Accounting Systems

A. Premchand and L. Garamfalvi

The success of the formulation and implementation of appropriate fiscal policies is dependent, to a very substantial extent, on the strength of the fiscal institutions in general, and budget and accounting systems in particular. These systems in the centrally planned economies had extensive influence on a number of countries that adopted central planning at a later stage and on countries that had a mixed-economy orientation. These systems had also some impact on the literature on planning and budgeting. Despite this extensive influence, however, the literature available on the subject is relatively small. The need for heightened awareness of the various aspects of these systems, both in theory and practice, arises from two interrelated considerations. The first is the extent to which the systems had contributed to fiscal distress and to the consequent general disillusionment with the economic system. The second is the type and extent of improvement needed in the systems to be adapted to meet what are perceived to be the general needs of a democracy and a market economy. This paper therefore is devoted to a description of the budget and accounting systems in centrally planned economies—their features, themes, and limitations—and a discussion of the issues and vulnerable areas, as well as the ways in which the transition may be made to market orientation.

Some caveats relating to the description of the systems and discussion of issues should, however, be noted at the very outset. The features described have developed over a period of time. While historical antecedents are briefly alluded to wherever appropriate, the description refers to the features found in the late 1980s.\(^1\) The picture is drawn from a variety

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\(^1\)Readers interested in an extensive discussion of the development of the sys-
of countries and should therefore be viewed as a composite rather than as an individual country description. The systems had widespread application of varying intensity. In addition to the U.S.S.R. and Eastern European countries, the systems in Algeria, Angola, Benin, China, Congo, Cuba, Ethiopia, Guinea, Lao People’s Democratic Republic, Mongolia, Mozambique, Myanmar, Somalia, Tanzania, and Viet Nam represent variations on a theme and have a common framework. In some cases, the framework as applied in some of these countries was, for all intents and purposes, the same as was in practice in the U.S.S.R. In some countries, some features of the Soviet system were adapted to the local conditions, while in others they became additional features to the traditional machinery. The discussion of the features primarily relates to those that are common to these economies and follows more the orientation of an economist than that of either an accountant or a student of public administration. Moreover, the evaluation of the system is not in comparison with any ideal system, but primarily in terms of the strengths and weaknesses relative to the expected goals and tasks.

Structural Aspects of the Systems

The approaches to decision making and the values that underlie the decisions basically reflect the institutions, structures, systems, and techniques used by governments. In this regard, centrally planned economies offer some uniform features. Essentially, the budget and accounting systems in government reflect a value chain in which the role of each one and the complementarity among the components in the decision-making pyramid are carefully designed. As Pryor (1968) noted some time ago, the institutions responsible for public expenditure management are more hierarchically organized in the centrally planned economies than in the market economies.

Important among the major instruments used by the government is the budget itself. Supplementing the fiscal policy articulated through the budget is the credit policy, which seeks to provide necessary monetary resources for the production system. In many cases, credit is used as an extension of fiscal policy and the banking institutions provide funds, often since the early days of the Russian revolution may see Davies (1958) and Campbell (1963). The official Soviet Government publication, Soviet Financial System (1966), is also, notwithstanding some turgid prose, a essential reading.

Two case studies, of China and Poland, respectively, are provided in Premchand (1990).
supplied from the budget and from their own resources as well, for the
purposes specified by the government. These development financial insti-
tutions, although called "commercial," do not receive or accept funds
from the public, but are used as conduits to pass on funds to selected
projects and programs specified by the government. Thus, an understand-
ing of the working of the fiscal policy would require an analysis of the
budget as well as the operations of the development financial institutions.
(In the overall paradigm of central planning, though the budget is given
some primacy, redistribution of national income also takes place through
the credit system, and through the mechanism of price planning.)

The national budget in centrally planned economies, following a princi-
ple of "democratic centralism," includes the budgets of the central gov-
ernment, regional levels of government (republics, provinces, and so
forth), and local levels of government (communes, municipalities, and
prefectures). The arrangement is an extension of one of the basic themes
of centrally planned economies, namely, "unified leadership and deco-
centralized management," although the origins of inclusion of provincial and
local governments in the central budget would appear to be more rooted
in expediency than in any ideal. The provincial and local budgets are,
however, prepared in conformity with the guidelines provided by the
central ministry of finance, and the budgets so prepared are reviewed and
consolidated by the central governments. Both types of budgets—central
and local (including provincial)—are expected to be in balance with no
deficits. During more recent years, however, this came to be applied with
some relaxation in that central governments were permitted to have defi-
cits while local budgets were to be balanced. The experience in this regard
differs among countries. For example, in China, provincial governments
are expected to be in balance but during recent years have tended to
accumulate payment arrears which, in a way, means that budgetary defi-
cits have occurred.

The budgets also reflect the extensive linkages between government
and public enterprises. In centrally planned economies, the state inter-
venes in all types of economic activities and practically all economic activ-

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"There are variations on this theme. An important exception to this is Yugoslavia
where each republic has its own budget. The federal budget is responsible for one
third of the total public sector finances.

"During the initial years after the revolution in the U.S.S.R., the republics were
permitted to draw up their own budgets, but as their response for the mobilization
of financial resources needed for "socialist reconstruction of the economy" was
less than expected, their budgets were integrated with the central budget and
"national budgets" came to be prepared. See Soviet Financial System, p. 84.

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ities are under state ownership. Traditionally, the state provides from its budget all the capital needed for the establishment of its enterprises, provides the needed inputs, and buys the outputs. The capital, until recently, was provided in the form of a grant, although as an integral part of recent reforms aimed at instilling an awareness of the costs of capital, some capital is provided in the form of a loan. It is, for this reason, that discussions of the capital structure of an enterprise, the relative roles of equity and debt, and the computation of the rate of return, tend to be somewhat alien in nature in centrally planned economies. In return for the capital provided, the state demands and receives in turn, in addition to turnover taxes, a share of the profits as well as a share of depreciation reserves.

The umbilical linkages between the government budget and enterprise budgets have, in most cases, two types of impact. First, is the growth of extrabudgetary funds. These are different from enterprise budgets which anyway are not included in the national budget. These funds were usually set up to provide a measure of managerial autonomy to budget units with own revenues to ensure a more efficient use of resources. The common characteristic feature of their financial relationship with the state budget is that if own revenues are not sufficient for carrying out tasks entrusted to a fund, they are entitled to receive subsidies from the state budget. Although the reasons for setting up extrabudgetary funds might have differed among countries, there appear to be four categories of funds.

1. **Separate state funds**—financed from earmarked fiscal revenues not transiting through the state budget and from subsidies from the state budget. These funds are entrusted with major tasks such as environmental protection, water supply development, road network development, and are supervised by agencies at the ministerial level.

2. **Budgetary establishments**—authorized to engage in profit-making activities in addition to their budgetary tasks. This category includes research institutes attached to universities or to university hospitals.

3. **Special support funds**—engaged in the provision of goods and services on a small scale, such as providing recreational facilities to employees of a ministry or day care for the children of employees, or other nonpecuniary benefit.

4. **Auxiliary funds**—set up as management units in support of activities, such as maintenance and repair of administrative buildings.

Extrabudgetary funds, which have grown in number, spawn a variety of activities, are frequently equivalent in size to the state budget, and have

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5This is the case, for example, in China. See the country study in Premchand (1990).
tended to blur the distinction between what is basically a budgetary task of the government and the task of an enterprise. More significantly, the unitary nature of the budget, while insisted upon in theory, remains obscure in practice.

The second impact is on the cash nature of the budget. The budget system in centrally planned economies is, in principle, cash oriented, in the sense that transactions are recorded when money is received or paid rather than at the point when liability has arisen. In practice, however, given the close links between the government budget and the enterprises, transactions may take place without any movement in cash. Thus, taxes due are routinely adjusted against subsidies to be paid or capital to be transferred. In addition, the budget itself shows total revenues net of subsidies paid to enterprises.

The systems in centrally planned economies also reveal a greater role for the central bank. All receipts and outlays of the state are received and paid out by the central bank and its offices. The central bank, in addition to meeting the day-to-day needs of the state, furnishes the initial accounts to the government which then prepares, on that basis, an annual financial report. The bank has thus a major role in the process of control over budgetary compliance.

The budget system in centrally planned economies has another notable feature that merits recognition. This relates to its classification of the budget transactions. On the revenue side, the approach of the classification is to make a distinction between taxes, profit remittances (included as a part of receipts from state-owned enterprises and institutional units), and other revenues. On the expenditure side, however, a distinction is made between productive and unproductive expenditure. (Lenin considered that the practices of bourgeois economists in regard to classification bordered on "official financial trickery." This distinction, which in a manner may be considered as an extended application of the one made by Adam Smith between productive and unproductive labor, separates the outlays on industry, agriculture, transport and communications, and related efforts as expenditure in the productive sphere, and outlays on social

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6This type of adjustment which started in the U.S.S.R. several decades ago was refined and formalized in the organization of the Social Accounting Service in Yugoslavia. This agency, set up in 1959, is the only financial recording agency for all the entities of the public sector. Thus, there are no delays in the payment of corporate taxes to the government or subsidy payments to the enterprises, for these are all carried through cashless book adjustments.

7For an illustration, see the country study on Poland in Premchand (1990).

services, defense, and administrative services, as unproductive.\textsuperscript{9} The sys-

tems do not, however, make any distinctions between current and capital
outlays.

The government accounting system follows a two-pronged approach in
that double-entry bookkeeping is utilized for production and enterprise
type of activities, while a single-entry system is used for normal service-
type activities of the government.\textsuperscript{10} As Campbell noted, these systems are
"virtually identical with traditional capitalist accounting."\textsuperscript{11} During the
budget implementation stage, spending ministries are free to authorize the
budget allocations after the approval of the budget. In most cases, the
productive agencies are each assigned a government-owned development
bank, which acts as a payment agency. In some cases, the bank is also
responsible for compiling the accounts of the agency for which it is acting
as a banker. In most countries, following the Soviet practice, taxes are paid
every ten days and accounting reports covering both receipts and expendi-
ture are compiled for each segment of ten days and for the month.\textsuperscript{12}

Financial Planning and Budgeting

One of the enduring contributions of central planning systems both to
practices and to the literature on budgeting is financial planning.\textsuperscript{13} Finan-
cial planning aims at building a proper bridge between production plans
and their financial implications. Planning in centrally planned economies
is essentially done in terms of five-year and annual plans that in turn are
based on the material balances approach under which the linkages among

\textsuperscript{9}From the national accounts standpoint, the system in CPEs makes a distinction
between that part of the national income which is allocated to the accumulation
fund (material production) and the part allocated to the consumption fund
(nonproductive).

\textsuperscript{10}See Campbell (1963), and the country study on China in Premchand (1990).
The major differences are in regard to the treatment of profits (which are distrib-
uted to various funds) and valuation of assets, which is invariably done in terms of
historical cost.

\textsuperscript{11}See Campbell (1963), p. 11.

\textsuperscript{12}Pryor (1968) makes a reference to other features of CPEs such as that budgets
are usually explained rather than debated. This aspect has, however, undergone
some changes during recent years in several countries. For example, in China, the
budget for 1991 was returned to the government for additional work before final
approval.

\textsuperscript{13}Financial planning was ushered in as an integral part of the New Economic
Policy announced by Lenin. Since then, both terms—New Economic Policy and
Financial Planning—have become part of policymakers' jargon. During the last two
decades, financial planning came to be practiced by industrial and developing
countries, with varying degrees of success. For a detailed account of these prac-
tices, see Premchand (1983).
various sectors are analyzed in terms of physical inputs and outputs. The
tasks of the state sector are conceived, in this process, primarily in mate­
rial terms, which are then converted into financial terms. But not all
activities of the state are converted into cash, for, as already noted, several
transactions may not involve any cash disbursements as appropriate
adjustments are made in the accounts. Thus, separate cash plans are pre­
pared. But these cash plans form only one of the many components of the
system as a whole (others include the financial plans of enterprises, collec­
tive farm sectors, capital investment plans, and so forth). The financial
plans normally cover a period of one year and thus are coterminal with
the budget rather than with the medium-term financial plans.

The basis of financial estimates is derived from the physical goals spec­
ified in the plan. Each sector of expenditure is given guidance on the level
of standards (or norms) in physical terms. These are then converted into
"standards in financial terms," which, simply stated, are a translation of
the physical standards into monetary terms, calculated at prices specified
by the government. Such standards are indicated for the whole economy, while
"budgetary standards" are applicable to the outlays financed from the
budget. Costs derived from these standards are labeled as standard
costs, although they refer primarily to the cash flows rather than accrued
costs. These costs are applicable for ongoing activities as well as projects
under construction and the maintenance aspects of completed projects
and are computed, approved, and enforced by the central agencies such as
the state planning commission and the ministries of finance.

On the basis of the above-mentioned standards and related assumptions
about the broad needs of the country, initial plans are prepared with
reference to which guidance is provided to the departments and the bud­
getary process is initiated.

**Budgetary Process**

The budgetary process, as usual, involves a number of organizational
steps that are common with other mixed and market-oriented economies.
The various phases involved in budget preparation are illustrated in Ta­
ble 1. It should, however, be added that the timetable shown therein is

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14 Here again, it would appear that the emphasis on material or physical aspects
was a natural alternative in the U.S.S.R. during the early years after the revolution.
During this period, high inflation was rampant and the value of money was being
eroded progressively. Planners preferred the emphasis on physical aspects, which
were then converted, for purposes of budget, into financial terms. Since then,
material balances have become a firm fixture in the landscape of planning (see
Davies (1958)).
The nature and the number of participating institutions may also vary among countries. Some aspects of the process illustrated in Table I deserve elaboration. The first relates to the process of review of investment plans and outlays proposed for construction, which also tend to dominate the budget. General guidance is provided as to the areas where investment is needed and the kind of production targets that are expected to be fulfilled. On this basis, the concerned agencies prepare a number of project proposals for review by the planning agency. Their scrutiny, which has varying levels of screening and which now is a common feature of investment planning in general, has come to be replicated in mixed economies. The major difference between the centrally planned economies and mixed economies is primarily the prices assumed for the purpose. In the former, prices reflect the valuation of the concerned official. In the latter, it is a linear extension of the market forces.

The second relates to the impression about the financial structure in centrally planned economies and the notion that all directives flow from the top down. This is true, but only partially, in the sense that all budgetary programs are reviewed, approved, and monitored by a central body which is usually the planning organization. But before final decisions are made, there is a substantial input from all concerned into what is included in the plan and the budget. During this phase, there is room for bargaining at every level. In some cases, this bargaining could even lead to a budget that is different from the financial equivalent of the plan prepared by the planning organization. Depending on the "systems politics" or the relative power of the planning and finance organizations, the plan may set the framework for budgets, or negotiated budgets may set the basis for plans. In addition, once the plans and the budgets are approved, operational flexibility is given to the agencies, subject, of course, to the compliance of various process controls (discussed further on). This operational freedom provides a relief from the high degree of centralization that may be implicit in the process.

The third aspect concerns the role of the legislature, and the role of the budgeteer in the process. Every financial system usually has an institution that is considered to be dominant by virtue of the responsibilities vested in it. Power comes from that dominant position. There is one seat of power in centrally planned economies which, for all external appearances, resides outside the government. This is the party congress. Its influence is not measurable, but practically nothing moves without its knowledge, involvement, and active assistance. Broadly, it is comparable to a legislature, but the way in which financial business of the government
### Table 1. The Budget Preparation Process

<table>
<thead>
<tr>
<th>Principal Activities</th>
<th>Participating Institutions</th>
<th>Timetable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Preparation of an annual draft plan based on the medium-term plan. The annual draft plan includes preliminary targets and limits for output and labor productivity. The draft plan is communicated to the ministry of finance, branch ministries, functional ministries, and to the national bank for information.</td>
<td>Central planning authority</td>
<td>February–March</td>
</tr>
<tr>
<td>2. Preparation of instructions, forms, and schedules for forthcoming budget year. Preparation of a preliminary balance of revenues and expenditures corresponding to annual draft plan. The preliminary balance accompanied by comments, explanation, and instructions is sent to branch ministries, functional ministries, and to the national bank for information.</td>
<td>Ministry of finance, Branch ministries, Functional ministries, National bank</td>
<td>March–April</td>
</tr>
<tr>
<td>3. Branch ministries prepare budget instructions for enterprises, based on the preliminary balance.</td>
<td>Branch ministries, Enterprises</td>
<td>April</td>
</tr>
<tr>
<td>4. Preparation of budget estimates for the forthcoming year in enterprises, branch ministries, and functional ministries.</td>
<td>Branch ministries, Functional ministries</td>
<td>May</td>
</tr>
<tr>
<td>5. Discussions of budget estimates, negotiations, and bargaining in view of “readjusting” targets and limits for outputs and inputs.</td>
<td>Central planning ministry, Ministry of finance, Branch ministries, Functional ministries, National bank</td>
<td>May–June</td>
</tr>
<tr>
<td>6. Preparation of a revised annual draft plan.</td>
<td>Central planning authority</td>
<td>June</td>
</tr>
<tr>
<td>7. Preparation of a revised balance of revenues and expenditures corresponding to the “revised” annual plan.</td>
<td>Ministry of finance</td>
<td>July–August</td>
</tr>
<tr>
<td>8. Budget negotiations between the ministry of finance, branch ministries, and functional ministries.</td>
<td>Ministry of finance, Branch ministries, Functional ministries</td>
<td>September</td>
</tr>
<tr>
<td>9. Preparation of the draft budget and submission to the council of ministers.</td>
<td>Ministry of finance</td>
<td>September</td>
</tr>
<tr>
<td>10. Discussion of the draft budget by the council of ministers. If approved, submission to the national assembly.</td>
<td>Council of ministers</td>
<td>October–December</td>
</tr>
<tr>
<td>11. Approval by the national assembly.</td>
<td>National assembly</td>
<td>November–December</td>
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</tbody>
</table>
is carried out by this body is different from any legislature. It has no taxing powers; it has no specified role for the introduction and processing of money bills. But none of them can take shape without the approval of the party.\textsuperscript{15} The life of a budgeteer in centrally planned economies is relatively smooth. The plan specifies the allocations and the basis for them, as well as the expected outcome. The plan is the basis on which spending agencies prepare their proposals. The plan also provides the basis for the budgeteer's existence in central and spending agencies. Inasmuch as everything is specified, his role is confined to fine-tuning the phasing of outlays submitted to him.

Also, insofar as a plan always concentrates on the incremental spending, the issue for the budgeteer is to deal with the increment, ignoring the ratcheted level of previous year's spending. Thus, each year's level becomes a part that is consigned to history and efforts are devoted to the slicing of the increment to the extent that such slicing is not fully indicated in the plan. Here again, the approach is one of fine-tuning rather than one that seeks a structural involvement. This atmosphere guarantees a minimum, and provides a certainty to the budgeteer that his counterparts in other systems would envy.

The certainty comes from a picture that is totally artificial. Macroeconomic stability is assumed. Prices are fixed by the government and do not reflect the market scarcities. It is this aspect which undergoes a total transformation as economies are opened and as prices, for the most part, are fixed by the market. The macroeconomic picture can no longer enjoy the stability (which, anyway, as noted above, is a doctored one) and will reflect the basic strengths and weaknesses of the economy. In the new environment, the primary task of the budgeteer is to come out of his long isolation and to recognize the impact of the macroeconomic aspects on the budget and the impact of the budget on the economy. This requires him to forecast, to carry his colleagues in the spending agencies with his forecast, to formulate his budget on the basis of that forecast, and to provide himself with contingency mechanisms to cope with the changes in the economy.

The control framework in centrally planned economies has been analyzed traditionally in terms of (a) preliminary financial control, (b) current financial control, and (c) post factum control.\textsuperscript{16} The first type of

\textsuperscript{15}It is not uncommon that the party adds its own proposals to the budget. In China, these are popularly known as "comrade-so-and-so" projects. This phenomenon is comparable to the pork-barrel approaches in Western democracies.

\textsuperscript{16}See Soviet Financial System, p. 347. Davies (1958), however, sought to
control is carried out during the review of budget estimates process to verify the accuracy of conversion of material values into financial terms. The second type of control is essentially a process or compliance control exercised within an agency at the time of incurring expenditure, and the last type of control is exercised after the transactions are completed and is a type of audit control. This brief description, however, does not do justice to the overall framework of controls that exists in centrally planned economies.

The control framework, reflecting the value chain system associated with centrally planned economies, has evolved over the years and covers budget transactions, extrabudgetary funds, outlays under the credit plan, and the outlays of the state enterprises for capital construction. The framework is also unique in that it reflects the unitary structure of the government. It is a vast one and includes policy controls, regulatory controls and process, and ad hoc controls. In addition, there are controls that relate to quantitative restrictions on the supplies of material inputs and of vital elements such as electricity (these are illustrated in Table 2).

In theory, it would appear that this ambitious framework offers a series of specified opportunities for interaction with agencies to coordinate their fiscal activities and to ensure, by and large, that the tasks undertaken are in accordance with agreed plans. Of specific importance is the fact that these controls are also applicable to the transactions of the provincial or decentralized levels of government. Policy guidance from the central government is both a part and an extension of the national plan. The two main components of this are the indicative guidance of the level of expenditures for each province for the next year and, more specifically, the level of investment to be undertaken regardless of the sources of financing. This guidance in turn reflects two concerns—the level of investment in the economy and the need to maintain a balanced budget in the provinces. By its very nature, it thus tends to be broad and the main responsibility for ensuring that the resources are effectively used to meet the local needs rests with provincial governments. As an integral part of this effort, the central government also takes into account the level of administered

analyze them in terms of "technical," "economic," and "efficiency" controls—technical control seeks to ensure that funds are spent for the purposes intended, while efficiency control refers to the use of resources. Economic controls are those that seek to ensure allocative efficiency (p. 203). The last one refers to the controls exercised at the budget formulation stage, while technical controls are the same as process or compliance controls. Davies concluded that, in practice, there were no efficiency controls except in terms of the logic of the norms or standards for each type of service.
### Table 2. Framework of Controls

<table>
<thead>
<tr>
<th>Policy Controls</th>
<th>Regulatory Powers</th>
<th>Process Controls</th>
<th>Ad Hoc Controls</th>
<th>Physical Controls</th>
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<tbody>
<tr>
<td>Direction of macroeconomic management</td>
<td>Determination of budgets for earmarked purposes</td>
<td>Review and compilation of agency budgets</td>
<td>Determination of supplemental budget allocations to</td>
<td>Specification of physical</td>
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<td></td>
<td>agencies</td>
<td>aspects of projects</td>
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<td>Determination of investment</td>
<td></td>
<td>Approval of investment budgets</td>
<td>Determination of provincial transfers to the center</td>
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<tr>
<td>Determination of price subsidy policies</td>
<td>Determination of extrabudgetary funds and their</td>
<td>Quarterly monitoring of central and provincial budgets</td>
<td>Determination of central transfers to provinces</td>
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<tr>
<td></td>
<td>activities</td>
<td>and reporting to the cabinet</td>
<td></td>
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<tr>
<td>Determination of domestic and foreign borrowing</td>
<td>Determination of loan component of national key</td>
<td>Submission of annual accounts</td>
<td>Determination of change in the annual budget in light of</td>
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<td></td>
<td>projects</td>
<td></td>
<td>changing economic events</td>
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<td></td>
<td>Yearsticks for personnel and wages</td>
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<td>Specification of budget and accounting rules</td>
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<td>Specification on the use of circulation funds unlinked</td>
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<td></td>
<td>by enterprises</td>
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prices, as well as the level of subsidies (both on specified commodities and those reflecting the operational losses of enterprises) and the levels of domestic and external borrowing. Thus, responsibilities for policies concerning the essential components of macroeconomic management are vested with the center. The impressive range of controls should not, however, be mistaken for effective controls.

**Strengths and Weaknesses**

The preceding brief discussion may give the impression that in all unimportant matters the systems in market economies and centrally planned economies are generally identical; the important differences are the extent of state ownership and its involvement in the economy, and as a corollary the emphasis on central planning. These systems have, however, revealed strengths and weaknesses over the years. Essentially, the weaknesses arise largely from the practices in each and every area of budgeting and expenditure controls, and the strengths are in the area of accounting and payment processes. Since the strengths are fewer than the weaknesses, it is appropriate that they are considered first.

The accounting system, which is primarily intended to insure against dishonesty and to provide documentation on the transactions of the government, is designed on the model of a commercial system and has been largely successful in providing timely data. That said, it should be noted that the central planners have tended to rely more on the extensive statistical system than on the accounting data generated for their policymaking and monitoring. Another area of strength is the relative abridgement of the payment process. The assignment of a bank to each spending agency has reduced the red tape and the numerous steps of verification associated with a number of other systems. That this aspect may have been given less importance may have been entirely due to the fact that in the dirigisme of planning, the focus is all on the upstream activities, that is, policymaking.

The weak areas are, however, too many. Basically, the systems have undergone little change over the years. That very feature would appear to have undermined its strengths. Further, some seeds of problems would appear to be inherent in the system. On the structural front, the establishment of numerous extrabudgetary funds has tended to overshadow the importance of the budget. In such a context, the real content of fiscal policy has been less clear. It could be argued that fiscal policy's lower profile was inherent in central planning and, therefore, the creation and functioning of extrabudgetary funds may not have been as problematic as it might appear. This has to be tempered, however, by a recognition of the
contradictions in the approaches of the budget, on the one hand, and extrabudgetary funds, on the other, and the frequent incidence of fiscal perversity in the activities of the extrabudgetary funds.

Another weak area has been the role of bargaining in the budgetary process. Although the extensive enumeration of plans and their components should, in theory, minimize the importance of bargaining, in practice it would appear that this has been quite prevalent. The organizational rationality has been such that each agency has endeavored to obtain enlarged budgetary allocations. Where this was not possible, resort was made to extrabudgetary transactions. Apart from this circumvention, as Davies noted, "the actual operation of a direct planning system . . . inevitably involves the emergence of illegal or semi-legal operations," by which the units or agencies have made efforts to adjust to realities and somehow or other scramble for materials and other inputs to carry out the specified projects. This contributed to the pursuit of a track parallel to the budget. Furthermore, insofar as legal channels are concerned, agencies have tended to manipulate data and selectively use "outside" support to obtain protection or a dilution in the directives of the central agency. The result has been that budgetary outcomes have often been different from estimates. To some extent, the role of bargaining could have been minimized through the formulation of a budget law. While centrally planned economies have had a number of decrees and associated regulations, they did not have a budget law as in other systems, to guide and discipline the budgetary process. The absence of such a law has tended to encourage bargaining.

The framework of control, while giving the impression of a neat and precise division of labor, has been and is a fragmented one, with too many institutions participating—often with overlapping spheres of control. By including all conceivable activities, the framework has lacked priorities and selectivity. More significantly, given the dependence on the transformation of material balances into financial terms, the budget and related planning did not provide for any margins of slippage or contingencies. The budgeteer, in that context, has looked to bargaining as an administrative safety net.

The major vulnerable area, however, concerns the way in which the resource constraint is internalized in the various stages of the budgetary process. In centrally planned economies, little allowance has been provided for the macroeconomic dynamics of resource shortage. As a Soviet official publication stated, "Socialist finance is always very stable. Financial

resources are growing continuously. There are no budget deficits and there is always a surplus of revenue over expenditure.” It added that “the issue of currency is not used as a source of revenue.” This approach has had a twofold effect. First, since the calculations of requirements have been made in terms of materials, or what has come to be known as volume terms, the agencies have had no need to think of financial implications. They were to be financed regardless of cost. Second, the focus of the agencies’ efforts has been on the increment in the aggregate. There has been, therefore, an innate compulsion to demonstrate a need for more resources, rather than to manage effectively the already available resources. Thus, each year’s expenditure levels have become the base for ratcheting upwards and they have tended to become progressively so as financial benevolence on the one hand, and defense needs on the other, have become, in most cases, inexorable. The absence of knowledge of resource availability may have become a powerful incentive and those responsible for budgets in the agencies would appear to have been less than aware of the claims of the additions on the resources. In that context, budgets that were not to have incurred deficits began to experience them and bank financing has become an automatic exercise. Normally, the emergence of the deficits would have contributed to the formulation of policies aimed at avoiding deficits. In the event, a weak budgetary machinery became, it would appear in retrospect, an unwitting ally to a policy failure. This combination may have contributed to the collapse of the system sooner than later. While it is always possible to argue that policy failure alone may have contributed substantially to this, the contribution of the budget machinery in building up a ratcheting expenditure process cannot, by any means, be minimized.

Toward a Market Economy

The issues referred to above need to be addressed, even if there were no efforts made to move toward a market economy. They acquire, however, greater urgency in the context of movement away from central planning. The systems need to be strengthened to meet the growing demands, and to reorient the systems so that they can be made more responsive.

19During the 1970s, expenditure planning in the United Kingdom was done in volume terms. This very soon contributed to a crisis and by 1981 forced the authorities to switch to a cash basis. For a more detailed account of this experience, see Premchand (1983), Chapter VI.
A movement to a market economy implicitly assumes a corresponding movement toward political freedom and the establishment of democratic forms of government. While there are variations on the theme or the content of a budget in a democracy, its two essential features are transparency and accountability for results. The former ensures that funds are applied for the process approved by the legislature. The budget itself should be transparent so that the full purpose of the outlays and the results likely to accrue are made clear. While it is recognized that some of the controls described earlier do ensure that funds are applied for the approved purposes, the exercise of the controls in the new setup will be more transparent so that, where necessary, the legislature itself could also oversee the day-to-day activities of the government. Transparency does not mean an open invitation to the legislature to micromanage. Rather, the intent is to provide a window of opportunity to monitor the performance of the executive part of government.\(^\text{20}\)

Accountability imposes additional tasks on the executive in that it has to ensure delivery of goods and services in an economic, efficient, and effective manner. As already noted, there is little incentive for government departments in centrally planned economies to economize; history also shows that there has been little concern for the delivery of services. These tasks impose, therefore, numerous additional responsibilities on the budget system.

The first imperative is to formulate the budget in the context of a macroeconomic framework with an explicit recognition and assessment of the linkages between the budget and the economy, and a reasonable assessment of prospective income and what can be achieved at what cost. Recent experience makes it abundantly clear that resources are—contrary to the previously cited assertion about socialist finance—limited, and that bank financing is finite. In this changed context, the capacity of the budget system needs to be strengthened so that resource realities are recognized at every stage. This would involve planning of a different type. It requires forecasting, on a rolling basis, the implications of each program and source of revenue so that there could be an explicit recognition of the parameters and determinants of each program and of the influence of policy decisions and other nonpolicy changes on programs. Spending agencies need to be informed of the ceilings on resources. These approaches, together with contingency plans or articulation of fall-back positions in the event of changes of assumptions or actual developments,

\(^\text{20}\)Poland has already enacted legislation specifying the role of the legislature in regard to budget matters. Hungary has formulated draft legislation in this regard.

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would show all concerned the impact of current policies and the margins available for expansion or the effort needed for scaling down some operations. In turn, these efforts result in the education of the public about the prospective benefits and impending burdens. Working within a macroeconomic framework would imply that resource allocation would no longer be a matter of ensuring increments, but downward adjustments too. The budgetary process needs to adapt itself to that significant change. The type and extent of change involved, for example, in the preparation of budget estimates, is illustrated in Table 3.

The budgetary machinery also needs to be changed in two other associated aspects. As indicated before, the national budgets in centrally planned economies also include the budgets of the local levels of government. This, however, has contributed to a good deal of overlap and frequent duplication in the efforts of central and local governments. There is now a need to clearly define the respective roles, responsibilities, and jurisdictions of the various levels of government in regard to revenues and expenditures. Further, as central banks attain a measure of autonomy, the relationship between them and the government, particularly in regard to the function of central banks as payment agent and as providers of short-term finances, would need to be specified.

The budget itself would need a good measure of consolidation in these economies. Apart from shedding the functions that have become redundant in the context of privatization, the opportunity has to be taken to draw the contours of coverage of the budget.21 As an integral part of this effort, the extrabudgetary accounts would have to be rationalized.

Introduction of the above-mentioned changes would also require supplementary organizational modifications in the ministries of finance. Apart from undertaking the type of rolling financial planning, the ministries may have to assume some of the functions that would cease to be performed by the central banks.22 Moreover, the ministries would have the obligation to monitor the implementation of the budget so as to ensure that the

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21Viet Nam has delinked state-owned enterprises from its budget in 1989. The system of taxation has moved from a sharing of profits to the taxation of profits. Financing of subsidies and capital expenditures (including circulation funds) from the budget has been stopped.

22Viet Nam is one of those few who have shifted these functions from the Central Bank (State Bank of Viet Nam) to the Ministry of Finance. A national Treasury has been established to be responsible for collection and payment of government monies, for the compilation of government accounts, and for the coordination of domestic and foreign borrowing. A similar effort initiated in Yugoslavia in 1990 did not make much progress, however, in view of the subsequent major political developments in the country.
Table 3. Impact of Market Orientation on the Government Budget: An Illustration

<table>
<thead>
<tr>
<th>Budget Items</th>
<th>Centrally Planned Economic System</th>
<th>Market-Oriented Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes on nonagricultural</td>
<td>Private sector's role not significant in the economy. Revenues are negligible.</td>
<td>The importance of private sector activities will dominate economic activity. Income</td>
</tr>
<tr>
<td>cooperatives and private sector</td>
<td>Value of turnover constrained by price controls; revenues stagnant.</td>
<td>taxes will gradually increase in importance and become a major revenue source.</td>
</tr>
<tr>
<td>Turnover tax</td>
<td></td>
<td>Free market pricing will ensure buoyancy of turnover taxes if rates are adjusted.</td>
</tr>
<tr>
<td>Profit tax</td>
<td>Profits are regulated; revenues are stagnant.</td>
<td>Profits determined by market demand conditions and corporate profits will increase in</td>
</tr>
<tr>
<td>Commodity taxes</td>
<td></td>
<td>importance as market expands. Tax administration should be developed to avoid lags in</td>
</tr>
<tr>
<td>Agricultural tax</td>
<td>Insignificant, and cumbersome as it was in part paid in commodities. Difficult to value.</td>
<td>payment and evasion.</td>
</tr>
<tr>
<td>Trade taxes</td>
<td>Revenues constrained by artificial transfer prices from COMECON, and distorted exchange rates did</td>
<td>Market-related exchange rates help dampen excess demand, and taxes on</td>
</tr>
<tr>
<td>Taxes and transfers from SOEs</td>
<td>not reflect scarcity value of traded goods.</td>
<td>international trade are very important sources of revenues. Difficult to collect and</td>
</tr>
<tr>
<td>(state-owned enterprises)</td>
<td></td>
<td>elastic if rates are adjusted.</td>
</tr>
<tr>
<td>Crude oil exports</td>
<td>Local value depends on exchange rate paid by special trading agreements.</td>
<td>Nonprofitable SOEs will be subject to restructuring. Profits will be</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Budget Items</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Nontax revenues</td>
<td>Fees set at artificially low levels.</td>
<td>Inflation adjustments of fees and cost recovery measures will improve receipts.</td>
</tr>
<tr>
<td>Expenditures:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages and salaries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic wages</td>
<td>Fixed wages are supplemented by commodity rations.</td>
<td>Automatic adjustments indexed. If wage adjustments are not fully indexed with inflation, the wage bill can be controlled in real terms.</td>
</tr>
<tr>
<td>Transfers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security Fund</td>
<td>None, because prices are subsidized.</td>
<td>Social security funds will cost government in the short run but the cost will be much less than provision of subsidies under centrally planned economies.</td>
</tr>
<tr>
<td>Transfers for working</td>
<td>SOE losses and working capital requirements automatically covered irrespective of efficiency considerations. Open-ended subsidies of SOE operations.</td>
<td>Very limited. Reliance on banking system finance encourages financial discipline and more efficient utilization of resources; lower outlays.</td>
</tr>
<tr>
<td>capital of SOEs.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subsidies</td>
<td></td>
<td>Subsidies for production by SOEs eliminated. Open-ended subsidies for consumption goods abolished. Prices will improve resource allocation and solve problem of excess demand. Limited subsidies to essential inputs can be phased out as markets develop.</td>
</tr>
<tr>
<td>Food procurement</td>
<td>Major expenditure items. Production subsidies to cover SOE losses and consumption subsidies result from prices set at below cost. If costs cannot be reduced, the subsidies are open ended and inefficiencies increase government expenditures and contribute to inflation and cost hikes in a vicious cycle.</td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>Depend on size of debt (domestic, foreign); interest rates and exchange rates which were held down artificially reduced outlays but had serious disincentive effects on the economy.</td>
<td>Depends on size of debt; interest rate reform and free exchange rates will increase outlays, but should encourage more responsible borrowing for clearly more productive uses.</td>
</tr>
<tr>
<td>Goods and services</td>
<td>All purchases determined according to plans and reflect dominant role of public sector. Costs do not reflect market value and thus do not encourage efficient utilization of goods and services.</td>
<td>Volume of purchases will decline in real terms as more activities are taken over by private sector. However, costs will reflect market prices which will require higher unit cost. Value for money considerations should be encouraged to improve efficient use of outlays.</td>
</tr>
<tr>
<td>Administrative expenditures</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating and maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services (education and health)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Other (excluding security and military)  

- Depends on size of operations; lack of correct valuation of resources may encourage excessive outlays.

Capital expenditures  

- Large outlays; determined according to material balances in plan. Evaluations distorted by using artificial prices, interest rates, exchange rates which may result in wrong priorities for investment. Excessive emphasis on heavy industry, self-sufficiency, and protection.

Fiscal deficit (excluding grants and government financing requirements)  

- The deficit is determined according to plan. Excessive fiscal deficits should be avoided but if they occur are not considered economically significant since price changes are controlled; thus, excess liquidity (monetary balances) generated from government savings will have to be offset by “forced” household savings. This is manifested in shortages of supplies relative to demand at the official prices.

Foreign borrowing (net)  

- Barter trade transactions are the means of payment. The relative competitiveness of different countries is not measurable; loans have a large implicit grant element determined by non-economic factors such as solidarity considerations.

Convertible currencies  

- Budgetary impact is dependent on the amount of debt contracted.

Depends on size of operations; private contracting for supplies will eventually reduce outlays; exchange rate changes will increase outlays for import content.

Much smaller outlays limited primarily on infrastructure, as private sector takes responsibility for investment in the economy guided by markets. Appropriate prices and interest costs will guide investments to most competitive and efficient sectors.

The fiscal deficit is of critical importance to economic management throughout the year. The size and financing of the deficit affect economic activity and money supply. Deficit financing is the most important cause of inflation as prices are free to move and excess liquidity (monetary balances) generated from government dissavings will have to be offset by “forced” household savings. This is manifested in shortages of supplies relative to demand at the official prices.

Trade and loans among all countries are denominated in convertible currencies. Since repayment will be in hard currency, true international competitiveness of utilization of borrowed funds will determine the purchasing power of the domestic currency.
**Table 3 (concluded). Impact of Market Orientation on the Government Budget: An Illustration**

<table>
<thead>
<tr>
<th>Budget Items</th>
<th>Centrally Planned Economic System</th>
<th>Market-Oriented Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic borrowing Banking system</td>
<td>A balancing item by default in the financial plan; affecting the monetary balances held by the public with no outlet but savings at the banking system. Fully accommodating monetary policy ensures inflationary financing of the deficit; but inflation is not immediately recognized in the state-owned sectors.</td>
<td>Of critical importance to the level of credit in the economy. Liquidity in the economy increases by a multiplier effect as commercial banks and directly results in inflationary pressures (as more money chases a limited supply of goods). This excess demand also spills over to the external sector as excess demand for imports which causes a deterioration in the balance of trade. With flexible exchange rates the price of foreign currency (the exchange rate) will also devalue. Short-term monitoring of bank borrowing by government is a critical condition for financial management and stabilization program.</td>
</tr>
<tr>
<td>Nonbank borrowing</td>
<td>Not practiced.</td>
<td>An important stabilization policy instrument for short-term financial management. Interest rates will have to be remunerative. The instrument draws down liquidity from the economy for a short period to allow the fiscal measures to take hold (they usually do so with a lag). Without correcting the fundamental fiscal problem, interest payments by government add to the deficit and liquidity soon after.</td>
</tr>
<tr>
<td>Arrears</td>
<td>Regarded as an accounting problem.</td>
<td>Regarded as a form of credit with exactly the same monetary implications. Nonpayment to government of liabilities by taxpayers or borrowers has the same effect of governments lending to them in terms of liquidity in the economy and inflation. Arrears are an inflationary instrument of financing. External arrears are inflationary unless their value is sterilized in blocked accounts, and are frequently contributing to erosion of the real value of the currency.</td>
</tr>
<tr>
<td>Below-the-line accounts and contingent liabilities</td>
<td>Not significant; as the whole economy is largely public sector.</td>
<td>Domestic banks lending to SOEs, or foreign banks lending for projects, will seek to reduce their exposure to the swings affecting market conditions through acquiring a lower risk of sovereign debt. Unless the uses of loans were efficient, the contingent liability will turn to a real expenditure by government in due course. Control of government guarantees is a financial management practice.</td>
</tr>
</tbody>
</table>
Macroeconomic policies are on track. These aspects imply that finance ministries should have the capacity both to induce and deter certain actions.

Further, with a view to minimizing the role of "bargaining," in the process, a kind of budget law needs to be formulated. Such a law should not be a mere codification of the existing practices; rather, it should be the framework that embodies the above-mentioned changes and specifies the role of the legislature, ministries of finance, central banks, central and local government nexus, the role of spending agencies, and associated aspects.

Along with the above, accounting systems need to be strengthened so as to ensure the preparation of comprehensive accounts and provision of adequate cost information on various services. More important, it would have to serve the purposes of departmental management rather than being oriented exclusively, as has been the case, to the statistical demands of the central planner. This user orientation will, however, be successful only when the user himself is more aware of his own needs as a manager. This transformation is not merely inevitable, but a priority at this stage.

Management of Change

The changes indicated may, in theory, be introduced either in one sweeping action or more gradually. It has to be recognized, however, that the systems now existing in centrally planned economies have been developed over a period of years and, inevitably, change will also be gradual. Moreover, the recent experience with institutional development suggests that it is a medium-term task, more suited to long-distance runners than to sprinters. Also, it should be noted that the dismantling of central planning has not so far contributed to any major change in the way in which government budgets are formulated and implemented in these countries. While there have been expressions of intent to change the systems, change itself has been negligible.

But any effort at reform requires that more attention be paid to the management of change so that problems that may arise can be anticipated and addressed. This requires a strategy for the implementation of changes. Such a strategy has to be evolved, taking into account the financial and human resource shortages, differentiation in content to meet the heterogeneous requirements of the users, phasing of implementation, and more important, the availability of contingency mechanisms in the event of emergence of a new set of problems. Furthermore, due attention needs to be paid to the cost of proposed changes and their technological underpinnings. Plans of action need to be tested to ensure that there is a feedback
mechanism to address the problems. Also needed is a comprehensive understanding of the causation between action and result. Some changes may have instant results, while some will have long lags. The organizational bottlenecks such as inertia, legal obstacles, efforts at self-preservation, protection of territorial turf, comfort of the status quo, and ambivalence about the future also need to be taken into account. Values that have been acquired over four decades and that have become ingrained into thinking would take some time to replace. Meanwhile, the price that the community pays for this inertia is that its fiscal policy becomes a captive to the archaic systems. A beginning in this long journey is overdue.

References


Other sources consulted in the preparation of the paper include the following:


