GOVERNMENT FINANCIAL MANAGEMENT
Issues and Country Studies

Edited by A. Premchand

INTERNATIONAL MONETARY FUND
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INTERNATIONAL MONETARY FUND
Washington, D.C.

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Prefatory Note

Government financial management represents an area in which there are developments taking place all the time. The situations described in Part II containing country and regional studies reflect by and large the position in mid-1989. While every effort has been made to update the studies, it is not unlikely that, in a few cases, events have overtaken the description provided in the papers.

Any publication of this type involves the crucial assistance of several individuals. The editor is indebted in particular to the contributors, who have been most cooperative in preparing and, where necessary, in revising the papers included here.

Mrs. Yoke Kum Hee persevered cheerfully in typing various drafts and in preparing the final manuscript; Mrs. Elin Knotter of the Editorial Division provided assistance in seeing the book through publication. Her vigilant eye and keen understanding proved valuable assets. Mr. Philip Torsani of the Graphics Section designed the cover.

The opinions expressed in the following pages are those of the authors and do not in any way reflect or represent those of the International Monetary Fund or the organizations with which the contributors are associated.
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Introduction

A. PREMCHAND

This book is the result of a combination of two projects. The first project was a Seminar on Budgeting and Expenditure Control organized periodically by the International Monetary Fund to meet the requirements of senior officials of its member countries. The first part of the book represents the papers contributed to the seminar that was conducted in November-December 1989 at Fund headquarters in Washington, D.C.

The second part of the book was organized as a separate project to complement some of the editor’s previous work. Professor Jesse Burkhead and the editor organized a symposium of country studies during 1983-84, which was published in Comparative International Budgeting and Finance (New Brunswick, New Jersey: Transaction Books, 1984). Since then, a need was recognized to supplement it with country studies specifically devoted to the recent developments in government accounting and financial management. Accordingly, countries representing the diverse systems (British Commonwealth, French, centrally planned economies, Nordic, and Latin American) were selected, and authors were requested to contribute papers. To facilitate comparisons, a framework was outlined to the authors; the studies included in this book reflect that framework.

The need for studies on budgeting and on related issues in individual countries can hardly be overemphasized. Public sector management in general, and public expenditure management in particular have been under stress, and their capabilities are increasingly under scrutiny. This concern is only natural in a context in which it is recognized that the success of macroeconomic policies depends to a very substantial extent not merely on the mix of policies and their timing and phasing of implementation but also on the attention and effort devoted to improving microeconomic aspects. It is essential that fiscal management machinery be adequately prepared and responsive to the changing requirements of macroeconomic policies. In considering both these aspects, policymakers and administrators in government...
evince considerable interest in ascertaining the experience of other countries in facing the issues and the lessons of experience. This book attempts to provide a discussion of the issues, as well as the experience, and is offered as an aid to public discussion of subjects with a vital bearing on the effective functioning of the public sector institutions. Traditionally, budgeting, as a discipline, tended to be associated more with economics and public administration, whereas financial management has its roots in accounting. Notwithstanding the considerable interdependence between the two, they have been treated, regrettably, as separate, and thus the unique features of governments and public institutions have been ignored. For the purposes of this book, a broader view of financial management has been taken, and it includes budgeting, expenditure control, accounting, and financial reporting.

BACKGROUND TO THE SEMINAR

In announcing the first seminar on budgeting and expenditure control in 1980, it was noted that "numerous problems are being encountered in public expenditure planning, in the formulation and execution of government budgets, and in administering expenditure controls." The announcement further noted that "although many countries have acted to strengthen budgetary and expenditure control systems, progress has been uneven and difficulties persist. There is a need for a more precise identification of problem areas, assessment of their magnitude, and a discussion of possible solutions and their usefulness in specific situations." To a substantial extent, this statement holds good today and, while providing the continuing rationale for the seminars, also underlines the need for more attention to be devoted to some of these areas so that viable fiscal policies can be pursued. Some of the problems that were prevalent at the end of the 1970s and early 1980s have been successfully addressed. However, some continue, and meanwhile, new ones have emerged. Moreover, some new techniques that were envisaged as solutions to the problems then prevalent have since become problems in their own right and are now being addressed. The changes in the size and structure of the public sector, on the one hand, and the continuing budgetary strains, together with emerging demands on public resources, on the other, are contributing to an intensive discussion on the need to scrutinize critically the methods in use for recognizing the resource constraint and internalizing it in government operations and for raising public sector efficiency in general. This debate emphasizes the need to identify the forces of change and to establish an analytical
framework to review the policy and technical responses to those changes and to develop principles and criteria for evaluating those responses.

**ISSUES AND OPTIONS IN THE EARLY 1980s**

The secular growth in expenditures and the accompanying policy implications have generally received considerable attention, and measures were taken to mobilize additional revenues or to reduce expenditure growth. But these efforts have not been entirely successful, and along with a variety of other factors—such as pressures for maintaining political, social, and economic commitments—this failure has led a number of countries to follow permissive fiscal policies. The experience indicated the need for more comprehensive efforts to mobilize additional revenues, to reduce expenditure growth, and to strengthen the institutions, systems, techniques, and operational procedures of fiscal management. But in considering the steps needed to improve budgeting and expenditure control, five options appear to have been available.

*First,* there were those who argued that what was needed was not a strengthening of control mechanisms but a reduction in the size of the government. This view, however, was more philosophical in nature and even where there was a reduction in the size or in the rate of growth of the size, there was a continuing need for greater attention to control. Indeed, such attention tended to become more important as hopes were raised by the new mechanisms introduced as a part of this effort.

*Second,* the nature of the control itself was debated. It was recognized that the exercise of conventional control in terms of minutiae was not effective, nor was the idea of adding too many layers of control—interpreted not in terms of review of policies but in terms of verification—meaningful. Over the years, a gradual movement away from the candle-ends approach to financial control has occurred. Instead, a growing emphasis on planning and management has emerged. But even as this approach did not yield the results expected, the issue was raised whether more would be gained by returning to earlier practices. It appeared to be an option between planning on the one hand and technical control on the other. In reality, however, no option existed, because a planning system that does not recognize the control implications has little value, as does a control system that is devoid of planning.

*Third,* the issue was raised of whether the problems—present and future—should be solved by introducing new techniques or by a more
effective functioning of existing controls. Here, again, the choice was dependent on an objective assessment of the strengths and weaknesses of the existing machinery.

Fourth, the question whether the controls should be centralized or decentralized arose. What was more efficacious—a powerful central agency or a coordinated functioning of central and spending agencies, with the latter being given some degree of autonomy and responsibility? If controls were centralized during periods of acute financial stringency, should they be relaxed during periods of relative improvement? If controls were decentralized, what safeguards were needed so that central agencies could discharge their own responsibilities? These matters were not ones for which universally acceptable solutions could be considered. Rather, they were aspects that needed to be determined in the context of a country's own administrative traditions, economic context, and related factors.

Fifth, there was a choice in terms of the goals of a budget—between accountability and economic management. Although these two aspects were ascribed as being independent or mutually exclusive, in reality they were always symbiotic and could not be considered in isolation.

**TRENDS AND EVALUATION**

Countries made their own choices within the broad framework described above. Their responses were both structural and technique oriented. In contrast to the experience of the mid-1960s and the decade of the 1970s, the emphasis was not so much on formulating complex systems as on formulating pragmatic responses to selected aspects. Strengthening the existing systems rather than totally replacing them occurred, and often themes that were a part of the landscape of the 1950s were revived. Such a selective strengthening seemed only natural as several improvements of a systemic nature were made in the 1950s and 1960s. It appeared prudent to build on the existing foundation. The new phase of improvements covered, as in previous decades, a wide area. In structural terms, budget classifications were refined and new classifications were introduced to show the full implications of proposed outlays. Some governments gave up the traditional distinction between current and capital budgets, while others that had never had a capital budget began to explore the advantages and feasibility of introducing one. There were more attempts to measure and contain costs, although the efforts to measure and enhance productivity in government did not yield any quick results. New techniques were introduced to understand the expenditure profiles of spending agencies and distinctions were made be-
between "running costs" and "others." Forward estimates in terms of rolling expenditure planning became a common feature, although critical comments have more recently been made on "current services baseline" budgeting. It is now viewed in some quarters as having "unfortunate and misleading effects" and a "curious wonderland quality" because it treats some spending programs as "immortal" and "inflation as an acceptable given." Budget deficits began to be analyzed in more detail, and now, at least 15 concepts of deficit are used for various analytical and operational purposes. Concerted efforts were also made to improve the management aspects of government programs, and similar efforts were and are being made to expand the application of electronic data processing and to reap the full benefits of these systems.

These efforts were neither universal nor uniform but indicate in broad terms their range. The issue is whether they were successful, whether they had a durable impact on the systems of budgeting and expenditure control, and whether the general goals of these systems are being better achieved now than before. While the importance of these issues cannot be denied, no systematic evaluation framework to reach answers on these vital matters yet exists. This is not to say, however, that there has been no evaluation. Quite the contrary. But most evaluations appear to reflect the immediate concerns of those evaluating and were often narrow in scope. Moreover, in some cases, it was too early to evaluate the new efforts as they were still being made.

**CURRENT PROBLEMS**

A quick analysis of international experience suggests several problems. Certain broad features of these problems may be noted in terms of six categories: (a) economy and the budget; (b) annual budget making; (c) targeting and tracking; (d) management improvement; (e) austerity management; and (f) approaches to expenditure control.

Recent experience clearly indicates that the budget has, of necessity, become more complex, reflecting the size and diversity of government operations. These features of government and the recent fiscal trends have emphasized the need to consider more explicitly the linkages between the economy and the budget and to provide for mechanisms that equip the fiscal machinery to deal with the volatility in the economy. While a good deal of progress has been made in formulating economic scenarios and in providing for contingency mechanisms, progress is still necessary on bringing revenue and expenditure planning together, improving allocations for public investment, relating manpower controls to expenditure programs, and
dealing with inflation. In some countries, budgeting continues to be an accounting exercise more concerned with the increment over the previous year's accruals and its distribution, thereby turning the implementation phase into an exercise in coping with the realities that were not recognized in the formulation phase.

Annual budget making, it is felt in certain quarters, is becoming an increasingly fruitless exercise. Flexibility is hampered by previous commitments, and the time-consuming process, while contributing to greater expectations and an apparent ability for more effective management, appears to have belied hopes. The argument for biennial budgeting—controversial in itself—is gaining ground. At least one industrial country has decided to move to a three-year allocation system under which about one third of government activities would be brought annually under more intensive scrutiny to achieve economies, and thus cover the whole government in a three-year period. While the benefits of a biennial or a triennial system remain to be fully demonstrated, the problems of annual budget making appear to be self-evident.

Budget is a framework intended to give coherence to what the government does and why. As an integral part of this framework, targets are set, and in effect each estimate, whether of revenue or of expenditure, is in itself a target whose attainment, or the failure to attain it, has an impact on other aspects of government work and on the economy. During budget implementation, a tracking network is needed to ensure that targets are being attained, or, if difficulties arise, that alternative strategies are being formulated. However, most tracking systems in government, including those in some industrial countries (as attested to by the country studies included in this volume), appear to need improvement. Reporting is still designed ostensibly for what is described as accountability purposes and not for the uses of the fiscal policymaker. Fiscal reports are generally incomplete, produced with inordinate delays, and in a form ill suited to the decision makers. This view has to be tempered by a recognition of the experience of several countries where more comprehensive reports are being obtained speedily, owing largely to the installation of electronic data processing machinery. The problem of the tracking system is that it has not been fully oriented to the needs of economic management, and doubts remain whether it has ably served accountability.

Improvement of management is still nascent. Measurement of the cost of programs remains largely unfulfilled. Although it was expected that a switch to the double-entry bookkeeping system would promote a greater awareness of cost aspects and a facility for computing costs, they have not yet been achieved. Even in those countries that have moved to double-entry systems, accounting is used as a
system for recording transactions and as a process for exercising repetitive (and mostly unrewarding) controls, and not for setting up performance indicators and assessment of efficiency. In fact, some argue that in a context in which more attention is to be paid to the management of fiscal crises, assessment of efficiency is less important. Postponement of efficiency considerations would not however avert or minimize fiscal crisis; it would have the unfortunate effect of exacerbating it.

Continuation of fiscal crisis over an extended period has made an austerity-oriented budget a compelling need rather than a soft option considered in the scenarios of a policymaker. Experience shows that there was little preparedness for the implementation of the austerity program, frequent resort to formula strategies with avoidable adverse impact on the programs, and needless centralization of power as well as a continuation of such centralization even after the crisis was over. Moreover, expenditure cuts could often not be sustained. It is debatable whether rectifying this adverse impact should be the primary item to be addressed in the next decade.

Finally, experience with expenditure controls shows periodic shifts from excessive fragmentation to excessive centralization. Often, controls did not appear to be responsive enough to the changing requirements. There was also no long-term agenda, and controls were often tactical, rather than strategic, with frequent changes in position without notice and often in a reverse direction.

In addition to the above, wide-ranging issues were encountered by countries with structural adjustment facility arrangements with the Fund. It is recognized that improved public expenditure management is a key to better government and accelerated structural adjustment. The problems experienced by these countries include inadequate public expenditure planning, obsolete budgetary structures and processes, poor monitoring of budget implementation, and ill-equipped government accounting systems. A measure of the importance attached to the need for improvement in these areas is to be found in the substantial share of fiscal conditionality in the overall framework of adjustment. The progress in implementing reforms has been somewhat slow, however, confirming the long-held belief that institutional improvement in the public sector requires a longer perspective.

**SEMINAR DISCUSSIONS**

The seminar covered a wide range of topics. Notwithstanding the differing background of the participants (drawn from developing and industrial countries, countries that were market oriented, as well as those that had hitherto had centrally planned economies), there was
consensus on several aspects. The principal themes and the views expressed are summarized below.

Public sector management in general, and financial management in particular, is in transition, and therefore more efforts to ensure a smooth management of change are indicated.

Problems of government financial management have a commonality and are not very different, in nature, from budget-surplus to budget-deficit countries. The experience of budget-surplus countries illustrates the readiness of governments to take timely action, which in part explains their current financial status. The credibility of the institutions engaged in public expenditure management needs to be restored through effective strengthening of the systems and operational procedures of financial management. Without such efforts, even greater erosion in the public's perception of the effectiveness of fiscal machinery is possible. The restoration of an environment that in turn would contribute to economic growth and stability was emphasized.

Given the transition of government financial management and the current economic context, an urgent need exists to review policies and to ensure that policies and procedures are not continued merely for historical reasons long after they are relevant or useful.

In view of the rapid changes in fiscal trends and related strains on the fiscal management machinery, it was felt that there was no permanent or once-and-for-all solution. Rather, the public authorities should regularly review their policies and operations and enhance their preparedness for meeting changing events and demands.

Because partial solutions have the potential for compounding problems, it is important that the linkages of these partial solutions to other elements of financial management be explicitly recognized and addressed.

Fiscal stress management requires a more concerted effort. Excessive reliance on the application of formula strategies, which may be politically expedient in the short term, was recognized as having the potential to lay the foundation for deferred or new problems.

Introduction of electronic data processing systems is not to be seen as a panacea for the ills of financial management. If the proper and expected benefits are to be derived from such systems, it is essential for institutions and systems to be specifically adapted to their requirements.

Expenditure control processes have become more rigid and in some cases have developed the potential to become counterproductive. It is necessary to ensure that they do not permit the triumph of procedure over purpose. They need to be reviewed further to adapt them to the changing requirements.
The need for incorporating some elements of corporate management, such as cash management, into government financial management was particularly emphasized.

Budgeting, in the final analysis, is a political process. The impact of political aspects on budgeting needs to be explicitly taken into account. The role of the civil service is to explore the alternatives and assess the implications of each course so that the choice of public policies can be conducted in a more organized, coherent, and empirical environment.

The introduction of rolling expenditure planning or forward estimates would facilitate a greater understanding of the continuing financial implications of current policies. Such financial planning has the inherent advantage of educating the public, the politician, and the civil servant on the current fiscal status of the government and on its future direction.

Structural adjustment involves changes in the orientation of institutions and systems. These changes are numerous and cover a variety of areas. It is important that a strategy be formulated to implement reforms first in the priority areas so that the energies of public authorities are not dissipated in too many directions.

Improvement of financial management in government is dependent on the cooperation extended by the administrative departments and agencies. Particular attention is therefore needed to enhance the capability and financial consciousness of the spending agencies.

The introduction of accrual-based accounting is desirable for ensuring proper disclosure of government transactions. However, implementation of the system is likely to be a long-term task. Meanwhile, efforts are indicated to ensure registration and monitoring of commitments.

Introduction of value-for-money approaches is likely to improve the effectiveness and efficiency of organizations. The technique should be viewed as an essential part of management culture rather than as a technique of auditing whose introduction depends on the initiative of the audit agency. Governments have an immediate need to improve the functioning of public organizations and to pursue excellence.

Increasingly, the budgetary outcomes are being influenced in some countries by active judicial intervention and interpretation of constitutional law. Although such intervention is only beginning, it is important for budget officials to be alerted to the impact of judicial intervention.

Pursuit of efficiency remains the goal of government financial management. The measurement of efficiency and effectiveness, however, remains to be refined further, as statistical techniques now being used have several limitations. Meanwhile, evaluation in government, both
internal to spending agencies and centrally implemented, needs additional stimulus.

The success of any innovation in government financial management is dependent on the attention devoted to human resource development in government. This area merits more concerted action.

**ORGANIZATION OF THE BOOK**

The book is divided into two parts. Part I contains the eleven papers considered at the seminar, while Part II contains nine country studies and one regional study. Each of the papers in Part I is structured to provide a background and a discussion of the issues, so that perspectives can be formulated on the current status and direction of future reform.

Tanzi’s paper on fiscal policy considers the evolution of the tasks of official policy and the issues that are being addressed. The editor’s paper seeks to present a survey of the issues in government financial management. Schick considers the political dimensions of public budgeting, specifically in the United States, and underlines the efficacy of external limits when escape mechanisms tend to dominate the scene. Basanti’s paper analyzes in some detail the role of public expenditure management in structural adjustment and the slow progress in achieving institutional and systemic improvements.

Specific technical aspects are considered in the next seven papers. One of the common efforts, in both industrial and developing countries, relates to the introduction of rolling expenditure planning. Keating and Rosalky’s paper provides a detailed insight into the Australian experience in this regard and the transformation that took place over the years, from a stage of considerable reluctance to the publication of forward estimates to a firm commitment to ensuring the integrity of the system. The editor’s second paper offers an analysis of the types of expenditure controls and the extent to which they have been successful. It also outlines the urgent need for addressing the institutional framework, and, more specifically, the importance of avoiding new layers of control in the rush to strengthen control. Staats considers the dual requirements of accounting—for purposes of disclosure to facilitate accountability and to serve as an aid to management—and notes that, despite years of debate, what has been achieved on both fronts remains small relative to the long agenda for future action. These aspects are further buttressed by the papers of Points and Wesberry in Part II. The issues of cash management illustrate an area in which the public sector stands to benefit from the experience of the corporate world, and these aspects are reviewed in De Zoysa’s paper.
Measurement of the efficiency of the public sector is one issue on which there is considerable agreement about the need for it, but the progress in evolving a viable system and its application is relatively slight. Clearly, two ways of approaching the problem exist— that of the administrator and of the economist. Invoking the original distinction made by Pigou, it appears that the administrator tends to make use of such tools as are available, while the economist aims at providing more refined tools. Refinement is, however, an ongoing process. Diamond’s paper surveys the literature on this important issue and presents a discussion of the state of the art.

Even as progress is being made in the measurement of efficiency, it is becoming increasingly clear that a more holistic approach toward improving the functioning of government organization is necessary. In this pursuit, the audit organization has a constructive role to play. Dye’s paper details the effort made in Canada to introduce value-for-money approaches to improve the functioning of organizations. In particular, he considers the constraints affecting the organizations and the issues that need to be addressed.

Another aspect that is gathering some momentum relates to judicial interpretation of law and its impact on budgets. It is likely that in future citizens will resort to the legal avenues to ensure equity in the provision of amenities and benefits to the community, particularly in a context in which provision of services by third parties but financed by government will be dominant. These aspects are examined in Axelrod’s contribution.

Part II consists of the country case studies. The paper on Australia covers all the aspects of government financial management, including the forward expenditure planning considered in detail in Keating and Rosalky’s paper.
Part I: Issues
Fiscal Policy for Growth and Stability in Developing Countries: Selected Issues

VITO TANZI

INTRODUCTION

Over the past decade two major intellectual developments (some would call them revolutions) have had a major impact on how economists and policymakers think about the way policies affect economies. The first of these revolutions is associated with a growing body of literature that goes under the name of “public choice.” In 1986 James Buchanan received a Nobel Prize in economics for his seminal contributions to this literature. The second is the less unified, but highly influential, thinking that goes under the name of supply-side economics. Supply-side economics had its major expression in the United States under the Reagan Administration. Its influence has progressively spread to other countries, both developed and developing.

Major recent changes in tax reform, in privatization, and in deregulation have been facilitated, and perhaps even promoted, by these two major developments. The present paper discusses some of the implications of these developments for fiscal policy in developing countries. It does this in part by focusing on some of the basic but implicit assumptions that guided fiscal policies in the past and that still guide many current policies. The two developments mentioned above have had powerful implications for fiscal policy. In general they have tended to reduce the desired role of the government in the economy.
HISTORICAL BACKGROUND

The term "fiscal policy" applies to the use of public finance instruments to influence the working of the economic system to maximize economic welfare. However, this is too vague a concept to be the focus of specific policy measures. For this reason, policymakers concentrate on more specific objectives, such as reduction of the rate of inflation, acceleration of the rate of growth, and redistribution of income. The activities of the public finance authorities are generally classified under four broad functions: allocation of resources, redistribution of income, stabilization of the economy, and the promotion of economic growth.

The allocation of resources is the function that has been emphasized for the longest period of time. At least since Adam Smith wrote the Wealth of Nations in 1776 it has been recognized by economists that an organized society requires certain goods and services whose technical characteristics (indivisibility, jointness of production, etc.) make their provision by the private sector unprofitable. These so-called public goods include defense, law and order, justice, basic education, and provision of roads.

Early in this century the need to redistribute income began to attract the attention of economists and governments. It was realized that the distribution of income that would result from the working of the economy might not be the one desired by society. Governments began to worry about the disabled, the old, the very young, the unemployed, and other particular groups that, without government assistance, might end up with incomes below some poverty line. In recent decades, governments have taken upon themselves the responsibility of supporting the consumption of various groups and, as a consequence, public spending for transfer payments has grown at a very fast pace. The concern for redistribution is largely a product of this century. Today some societies pay more attention to the distribution of income than others and are more willing to sacrifice other objectives (such as efficiency) to pursue the objective of a better distribution of income.

The third function, stabilization, is even more recent than redistribution as a legitimate objective of the government. The idea that the government could and should explicitly try to stabilize the level of aggregate demand through its own public finance activities originated with the writing of John Maynard Keynes in the 1930s. It implies that government revenue and expenditure should be used as instruments to reduce cyclical variations in economic activity.

In industrial countries the role of the public finances encompasses the foregoing, since growth is generally expected to follow automati-
cally from the proper pursuit of those three functions. However, in developing countries, with income levels much below those of the industrial countries, it has often been argued that growth should be an explicit and separate objective of policy. It is argued that the government cannot passively accept the rate of growth that automatically results from the activities of the private sector but should actively pursue policies aimed at accelerating that rate.

The role of the government can be evaluated from two different angles: One focuses on what the government should do to promote the rate of growth of the economy; the other focuses on what the government should not do to avoid becoming itself an obstacle to growth. The first aspect emphasizes the potential or theoretical role of the government in mobilizing resources, in raising investment, in creating social and economic infrastructure, and so forth. The second, more passive, and more realistic aspect emphasizes the limitations of that role and the risk that when the government attempts to do too much it may create obstacles and difficulties. This second aspect is influenced by recent writing on “public choice” and on supply-side economics. It is an aspect that emphasizes the need to pursue policies that are more market oriented and that do not replace the judgment of the market with that of civil servants except where this replacement is justified by the presence of public goods and exceptional externalities. It is also an aspect that brings greater realism in economic policy.

Until the recent emphasis on supply-side economics, the governments of the developing countries were advised: (a) to increase tax revenue to mobilize more resources; (b) to increase public investment; (c) to promote private capital accumulation through investment incentives; (d) to take over many economic activities, especially through the creation of public enterprises, thus providing capital and managerial skills assumed to be lacking in the private sector. With increasing frequency governments are now (a) reducing tax-created disincentives; (b) privatizing public enterprises; and (c) reducing those regulations and policies that give much discretion to some public employees, such as those, for example, that grant import permits, tax incentives, and so forth. The recent tax reforms reflect a realization that the government should play a more neutral role in the economy.

**INSTRUMENTS OF FISCAL POLICY**

In their pursuit of economic objectives, the authorities rely on a variety of policy instruments which, at least in theory, can be manipulated to achieve particular social objectives. These instruments can be classified into broad categories or can be identified in terms of the
specific characteristics of each category. For the broad categories there are the revenue and expenditure instruments. Among the revenue instruments, the most important role is played by taxes; however, governments rely also on fees, on the prices of public utilities, and on sales of assets. In addition to providing revenue, each tax can also be used to achieve particular goals. For example, import duties can be used to influence the balance of payments; excise taxes can be used to influence consumption patterns, and so on.

Next, governments can finance the part of their expenditure not covered by ordinary revenues (taxes and fees) through foreign borrowing, borrowing from domestic nonbanking sources, and borrowing from the domestic banking system. Depending on their particular situations and on the objectives they wish to pursue, countries rely more on some of these sources than on others.

An important classification for expenditures is that between real expenditures and transfers. Especially in industrial countries, much of the growth in public spending over the years has occurred in the form of transfers. Another classification considered important by some economists is that between capital and current expenditure, on the presumption that capital expenditure contributes to growth while current expenditure does not.

The traditional theory of public finance assumes that the government can manipulate these instruments, both those on the revenue side and those on the expenditure or financing side, to achieve particular objectives. This theory, which goes back to the work of both Keynes and Tinbergen, is based on a series of strong but unstated assumptions that, in all countries but especially in developing countries, are often not realistic. As already mentioned, public choice and supply-side economics present major implicit challenges to these assumptions.

The first assumption is the one that views the public sector as a monolithic entity. It is assumed that within the public sector there is a focus of decision making that controls all public finance decisions in the country. The reality is obviously different. The public sector is not made up of one entity but of many, and, in some cases, literally hundreds of separate entities. Some of these entities have enough political power and independence that they can go on "doing their own thing" even when contrasting signals are being sent by the central financial authorities, such as the treasury or ministry of finance. This is particularly true for some large public enterprises, for local governments, and even for some ministries and social security institutions. At times these entities have objectives or perceived responsibilities that in some ways diverge from those of the ministry of finance. They may also have enough political power to ignore, or at
least to interpret in their own way, the instructions that they receive from the ministry of finance or the treasury. When this is so, the possibility of pursuing a rational and well-coordinated public finance policy to promote growth and stability is undoubtedly made much more difficult.

The second strong assumption made by the theory of public finance is that there is a clear and well-articulated public interest that is pursued by the individuals who make policy decisions, who interpret them, or carry them out. Unfortunately, the reality may sometimes be different. Policymakers, as well as the civil servants who must implement the decisions made at the highest level of government, may have their own interests. These interests may in part diverge from the public interests pursued through the chosen economic policy. This divergence is facilitated when, as is often true, the public interest is not well articulated. These private interests may originate from many sources: political or class affiliation, regional, racial, or tribal backgrounds, friendship or family ties, etc. When the divergence between the general interest and the private interests of those who must carry out the formal policy decision is substantial, the results of policies may differ from those anticipated. A common example of this divergence is provided by tax reforms that in some cases may not lead to major change in tax collection or tax incidence because the tax administration may de facto ignore the legislated changes.

The third assumption relates to the assumed superiority of information available to the government and to the presumed managerial superiority of public sector employees. Some of the original justification for expanding the role of the public sector was founded upon this assumption. The government was assumed to have access to information not available to the private sector. Furthermore, it was assumed that the government could provide managerial skills lacking in the private sector. Even if this assumption had some validity in earlier years, it is less valid today; first, because the information revolution has made much information available to everyone; and second, because in several countries (for reasons elaborated later), there has been a relative deterioration in the average quality of those who work in the public sector.

The fourth assumption is that the instruments of economic policy are highly controllable and that decisions can be easily reversed. In other words, the government will be able to increase or decrease particular taxes and particular types of spending as required by the evolving circumstances in the economy. However, some instruments are far more controllable than others, and some decisions can be made more easily when they require changes in some variables in one direction than in the opposite direction. For example, revenues from particular
taxes may be influenced by factors (such as inflation, changes in world prices) that are beyond the immediate control of the government. Furthermore, it is much more difficult to reduce taxes or increase spending than to do the opposite.

In the traditional theory of public finance, it is assumed that the instruments used to pursue economic objectives will be public finance or monetary instruments. In practice, governments often pursue their objectives through regulations. To some extent, regulations can replace public finance instruments. For example, the consumption of an imported product can be subsidized either through the budget or by letting the exchange rate become overvalued. In many developing countries overvalued exchange rates conceal a lot of disguised redistributational activities on the part of the government. The production of a given product can be subsidized either directly through the budget or by restricting the importation of competing products.

Regulations have far less transparency than traditional public finance instruments and may involve very high but hidden efficiency costs. They are often justified in terms of some apparently worthwhile objective (protecting employment) and seem to be costless. Furthermore, they have a low direct cost of introduction, since they can often be introduced without formal legislative enactment. There has, thus, been a tendency in developing countries to rely excessively on them. The net result is a situation where the economy becomes overregulated and highly inefficient. Moreover, economic policy appears haphazard and without a clear sense of direction. One of the merits of public choice and supply-side literature has been to focus on these aspects of public policies that had received relatively little attention in the past. This literature has called attention to the efficiency costs of regulations and to the likely abuses that often accompany them.

TAXES AND ECONOMIC GROWTH

In recent years a tendency has arisen to advise countries to reduce the size of the public sector. But how does one measure the size of the public sector? Traditionally, the focus has been on tax levels. Studies of tax levels tried to develop norms that would indicate the tax level that a country was likely to have, given its level of economic development, or (in the more normative approaches) the tax level that it should have. However, the tax level is not a good measure of the size of the public sector and its impact on the economy because it may not be closely related to the level of public spending and because it does not reflect the impact of the public sector through its regulatory instruments.
A country with a fiscal deficit has a level of spending that exceeds the level of taxation (including fees and other ordinary revenue); and public spending is probably a better measure of the absorption of resources by the public sector than tax revenue. Regulations on economic activities proliferate in these countries, and the impact of these regulations is, as mentioned above, often similar to that of traditional public finance instruments. Regulations are not quantifiable, so that it is impossible to compare quantitatively the impact of the public sector of different countries when they have different regulations. When regulations are taken into account, the conclusion is likely to be that in many developing countries the public sector may be far more pervasive in its impact than in industrial countries, even though the latter have much higher levels of taxation or public spending than the developing countries. However, if regulations can be easily circumvented through bribes, they may have more of a redistributional effect than an allocative effect.

For developing countries the ratio of taxes to gross domestic product (GDP) averages about 18 percent. There is some relationship between that ratio and the level of economic development, since as countries become richer the ratio of taxes to GDP normally rises. Tax levels in developing countries are also influenced: (a) by the level of public spending because, in spite of deficit financing, taxes still remain the major source of financing public expenditure; (b) by the structure of the economy, because some economic activities are easier to tax than others; (c) by social factors reflecting the attitude of the citizens vis-à-vis the government; and (d) by factors such as urbanization, literacy rate, and monetization of the economy. They are also influenced (e) by the structure of the tax system itself.

As the tax level goes up as a share of GDP, the number of taxes used by countries generally decreases. In other words, countries come to rely on a few productive taxes, rather than on many unproductive ones. As countries develop, the importance of foreign trade taxes falls, since governments recognize that these taxes distort the allocation of resources and retard the rate of growth of the country.

A modern tax system will rely to a considerable extent on general sales taxes and on income taxes. In recent years, economists have favored taxes on consumption more than taxes on income. A general sales tax applied at just one rate (or with very few rates) is preferable to sales taxes applied with many rates. Some studies have shown that the benefits, in terms of equity, achieved through a multiplicity of rates are small while the administrative costs of using multiple rates are considerable. When a country wants to single out particular items for heavier taxation (such as tobacco products, spirits, petroleum products, and some luxury items), it is preferable to do it through...
excises. The attitude vis-à-vis the structure of income taxes has also changed in recent years. In the past these taxes were normally applied with high marginal tax rates. The current thinking is that high marginal tax rates have serious disincentive effects and, by providing a strong stimulus to evasion, have also serious equity implications. Also the attitude toward tax incentives has changed. Many economists now prefer a tax system with lower tax rates, applied without exceptions, to one with high tax rates accompanied by tax incentives for some activities.

In conclusion, the structure of taxation most favorable to the growth of a country is one that relies on taxes with broad bases and low and relatively undifferentiated rates. A general sales tax, often of a value-added type, and a broad-based income tax should be the keystones of modern tax systems. These two taxes should be accompanied by excise taxes on traditional sources such as tobacco products, spirits, petroleum products, and on some luxury items. Depending on the need for large revenues, some countries may have to impose taxes on imports. Taxes on imports should be levied on all imports at low and relatively undifferentiated rates. High import duties should not be used to discourage the consumption of luxury products, since that may create an incentive to the domestic production of those products. Luxury consumption can be discouraged more efficiently with excises. Nonetheless, it is preferable to have high import duties than to have quotas and other quantitative restrictions.

Taxes on property remain an important, though underutilized, element of tax systems. They are important for the financing of local services. However, considerable administrative attention is required to keep the assessments of properties close to their actual values. Unfortunately, these taxes do not fare well in countries with inflation, and they have been losing importance in the tax systems of many countries.

Tax systems should reflect other important characteristics. They should be simple, since a complicated tax system can rarely be efficient and fair. Complications encourage tax evasion and tax avoidance, create a perception of unfairness, increase investors’ uncertainty about the tax system’s implications and effects on planned future activities, and increase the discretion of tax administrators. Too much discretion on the part of tax inspectors is likely to lead to corruption. A tax system should also be transparent in the sense that it should provide a clear picture of its incidence. A tax system that relies on general sales taxes and on broad-based income taxes would normally exempt the very poor from taxation, as people with very low incomes rarely pay income taxes and much of what they consume is generally exempt from consumption taxes (for example, subsistence
production). A tax system that depends on many taxes and on many rates is neither simple, nor transparent, nor likely to exempt the poorest individuals from taxation.

PUBLIC EXPENDITURE AND ECONOMIC GROWTH

In recent decades, the ratio of government expenditure to GDP has increased in most countries. In many countries its present level cannot be financed by ordinary sources of revenue. As a consequence, many governments have been compelled to borrow heavily from foreign sources, thus accumulating a large stock of foreign debt, or from domestic sources, thus accumulating domestic debt or generating inflation and other pressures on the economy. The growth of public spending was justified on grounds that the government must promote economic growth, sustain economic activity, and bring about a better income distribution. The view was that, without this large growth in spending, economies would be anemic and unstable and the distribution of income would be less even. Yet those with an interest in economic history will be aware that in many countries income distribution has not improved much over long periods; economies have not become more stable because of governmental intervention; and the rate of growth has not accelerated because of the larger involvement of the government.

The period between 1870 and 1913 is considered by economic historians as one of the most dynamic periods for the economies of the modern world. In that period the rate of growth of countries was normally very high, and much modern infrastructure such as railroads, roads, and schools was built, especially in industrial countries. Yet the level of public spending in the industrial countries was remarkably low. For example, in France it was only about 10 percent of national income, and similar percentages are found for the other countries. These percentages raise doubts about the essentiality of a large public expenditure in promoting economic growth.

Public spending is needed to create the social and economic infrastructure that allows an economy to grow and achieve a high level of income. An economy without good railroad facilities, good roads, good schools, adequate health care, and many other institutions (a police force and a judicial system) is unlikely to become a modern economy. But special care must be taken to ensure that the spending for this infrastructure is carried out efficiently and allocated to the most productive uses. In many developing countries, there has been a tendency to favor new projects at the cost of the existing infrastructure. New roads have been built while the existing ones were allowed to deteriorate; new irrigation schemes have been created while the
existing ones were not properly maintained; new schools were constructed while the general level of education was allowed to fall because of lack of textbooks, good teachers, and other facilities. Usually, more attention has been paid to carrying out new investment projects than to maintaining the existing infrastructure in good working order or to utilizing it at full capacity. Often, new projects that would generate low rates of return were financed by foreign borrowing obtained at high cost.

The gap between the rate of return on investments and the costs of servicing the capital borrowed to finance them has created difficulties for many developing countries. A general, obvious, and simple rule, which unfortunately is often forgotten, is that no public spending financed by borrowing should be carried out unless the expected rate of return on it at least equals, and is preferably higher than, the cost of obtaining the resources. This rule is especially relevant when spending is financed with borrowed external funds.

Before new projects are approved, existing infrastructure should be put into good working condition. Expenditures for operation and maintenance should be given priority, even if it means reducing the level of investment. Building a new road has no point if existing roads are allowed to deteriorate for lack of repair. The same applies to other sectors.

An area that deserves special mention in discussing public spending is public sector employment. In many countries public sector employment has been expanded beyond the level needed largely by reducing public sector real wages. In these circumstances the quality of the civil service deteriorates, leading to an even larger decline in its productivity.

When real wages fall below some level imposed by comparability with the private sector, some unhealthy developments for the economy take place. Low real wages, together with politically motivated hiring, make employees feel that the salaries they receive are almost an entitlement or a pension. Job shirking becomes common. Public employees begin to get second jobs and to allocate more of their energy to the unofficial jobs. Their honesty is also affected. Corruption finds a fertile ground in situations where real wages have become too low. This problem is especially serious in tax administration, where low wages are likely to increase the receptiveness of tax inspectors to bribes, but it is not limited to that sector.

The reduction of real wages is often accompanied by a flattening of the salary scale. In some developing countries the difference between the lowest salaries and the highest salaries in government jobs has been reduced to a much greater extent than in the private sector. As real salaries in the public sector are sharply reduced—especially for
those who are charged with making important decisions—an exodus of the most able and best trained is likely, since they can most easily get jobs in the private sector. Except for highly motivated individuals, or for some who may take advantage of their positions to generate additional incomes, those left in government tend to be those with less marketable skills.

The wage bill should be reduced by reducing numbers of employees and not real wages unless the latter have become high because of union power or other factors, compared with the income level of the country or the wage level in the private sector. In this process the structure of wages in the public sector must receive close attention. When the general level of wages, especially for key personnel, falls much below the level in the private sector, the quality of public sector activity inevitably deteriorates, bringing with it serious costs to the economy. This is an area that, in spite of its importance, has attracted little attention. The ultimate objective should be a public sector made up of a small, efficient, and relatively well-paid civil service.

One of the modern characteristics of countries is the large share of subsidies and transfers in the total budget. One reason why the level of spending in national income was so much lower at the beginning of the century was precisely because these subsidies and transfers were almost nonexistent. Selective transfers to groups that, because of handicaps, advanced age, or particular situations, are so poor that they cannot take care of themselves are obviously fully justified. Unfortunately, in modern economies transfers are so generalized that they cannot truly be defended as an instrument for improving the income distribution. The moment the government begins to broaden its involvement in sustaining certain prices or in sustaining certain incomes, it opens itself to political pressures from groups that do not need that assistance but that can always make a case for getting it.

The basic message that comes out of this discussion is one that emphasizes the need to reassess many of the activities of the government and to ask specifically the reason why the government is involved in certain activities.

**FISCAL POLICY AND STABILIZATION ISSUES**

A country undergoing an economic crisis, associated either with inflation or with large disequilibria in the balance of payments, is unlikely to sustain a good rate of growth. Developing countries are more prone to economic instability than industrial countries, since they are exposed to a variety of external shocks that affect their economic performance. These shocks may be associated with changes in
export earnings, since many of these countries rely heavily on the export of one or more commodities for their foreign exchange earnings. They may be due to (a) changes in the prices of major imports (oil); (b) changes in the cost of foreign borrowing, as happened in the early 1980s when real interest rates rose sharply; (c) changes in the availability of foreign credit, as happened after the debt crisis of the summer of 1982 when banks became much more reluctant to lend; and (d) changes in the level of foreign grants.

These external shocks do not affect just the incomes of the countries, but also their fiscal accounts, because of the close link between the budget and the foreign sector. This link depends on (a) the proportion of foreign trade taxes in total revenue; (b) the proportion of domestic sales taxes collected from imports; (c) the reliance on corporate income taxes collected from companies that export mineral products; (d) the reliance on the part of the public sector on foreign borrowing or foreign grants; (e) the proportion of foreign debt that is public; and (f) the attempt to insulate some domestic prices from movements in world prices.

Foreign trade taxes account for about one third of total tax revenues in developing countries. If one adds to this the share of corporate income taxes collected from mineral exports, and the share of taxes on goods and services levied on imports, it appears that about 50 percent of the total tax revenue of developing countries may be directly related to the foreign sector.

Ideally, a government with fluctuating revenue should base its expenditure on the average (or trend) level of taxation and other current revenue over time. This relationship implies that the country should run a budgetary surplus in good years and a deficit in periods when exports are lagging behind their trend level, or when other negative factors predominate. Thus the government would accumulate assets (or reduce the debt) in good periods and run them down (or increase its debt) in others. To some extent some of the oil exporting countries have done this. Kuwait, for example, accumulated large surpluses in the period after 1974, when the price of oil was very high, and has since then been using these surpluses.

In the majority of developing countries, however, periods of boom have often led to sharp increases in government spending. In some countries the increase in spending even exceeded the much higher revenues that had become available during the commodity boom. When the boom came to an end, they had expenditure commitments that could not be sustained by the current or even the long-term level of revenues, and that could not be reduced quickly. To make matters worse, the end of the boom in commodity prices was accompanied in
the 1980s by sharply higher interest rates and limited availability of foreign loans. The foreign financing of the deficit thus became more difficult and more expensive.

Fiscal deficits can be financed by domestic noninflationary sources, domestic inflationary sources, and foreign sources. Inflationary financing of the fiscal deficit distorts domestic prices relative to foreign prices, distorts tax revenue, and brings about many other complications. It is thus difficult to accept the notion that these costs do not overwhelm the benefits from the spending that is financed by it. Domestic noninflationary financing is normally quite limited in developing countries because of the size of their capital markets and because of the generally low saving rates by households. In addition, this type of financing, like inflationary financing, tends to crowd out private sector activities, although it is less likely to have inflationary consequences. This leaves foreign financing with all its complications and problems. Many developing countries are today facing the serious consequences of excessive reliance on this source of finance. The connection between financing of the fiscal deficit and the external sector often forms the basis for the involvement of Fund programs with the fiscal accounts of the country.

The implication of this discussion is that, over the longer run, a fiscal policy that is consistent with growth and stability will require bringing public spending into line with the average level of revenue expected over time. For a variety of reasons—some administrative, some technical, some political—there is in most countries some limit to the tax level and to the other sources of ordinary revenue. Thus it is often unrealistic to believe that unsustainable fiscal deficits can be eliminated solely or mostly by increasing taxes. A permanent reduction in the fiscal deficit must often come mainly from a reduction in the level of public spending, although the option of raising nondistortionary tax revenue should always be fully exploited. When public spending is reduced for stabilization reasons, the reduction in expenditure must follow clear criteria of efficiency. Cuts that follow the line of least resistance are often the wrong ones, although unfortunately they are often the first to be made.

A. PREMCHAND

INTRODUCTION

The management of government finances has been in a state of continuous development over the last four decades. This development can be traced largely to the changing tasks of the state and thus of the government. The changes were not merely in the style but also in the substance of economic management. Public money management practices have been seriously buffeted by the crosscurrents of changing economic conditions. Following the Second World War, budgeting appeared to have lost its traditional role of restraining public expenditure and came to be used for economic growth. More recently, after substantial growth in public expenditures and the ensuing fiscal crises, budgets once considered locked in had to develop a reverse capability to reduce expenditures and manage cutbacks without excessive distortions. Questions have shifted from “who is going to get more?” to “whose budget should be further reduced?” Between these extremes public money management has evolved from a practicing art to a still imperfect science. Although an analysis of this evolution (interesting in itself) is not attempted here, to provide an essential perspective to the discussion, Table 1 shows the evolution of public expenditure budgeting and the changing values and techniques of budgetary systems.

The concerns of this paper are much more immediate: the cumulative problems in the broad area of government financial management, the issues inherent in the current situation and those likely to emerge, and the consideration of available alternatives. Another aspect of this paper deals with the systemic constraints that have tended to impede rather than enhance the implementation of fiscal policies. The paper does not deal either with the policies or with other features that could
Table 1. Public Expenditure Budgeting

<table>
<thead>
<tr>
<th>Orientation</th>
<th>Purposes and Features</th>
<th>Techniques</th>
</tr>
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<tbody>
<tr>
<td>Control</td>
<td>(a) Ensuring legislative accountability</td>
<td>Line-item review</td>
</tr>
<tr>
<td></td>
<td>(b) Reducing expenditures or other growth rates</td>
<td></td>
</tr>
<tr>
<td>Management</td>
<td>(a) Ensuring legislative in-depth accountability</td>
<td>Performance evaluation</td>
</tr>
<tr>
<td></td>
<td>(b) Ensuring value for money spent</td>
<td>Performance measurement</td>
</tr>
<tr>
<td>Planning</td>
<td>(a) Planning for growth on the assumption that resources are available</td>
<td>Program budgeting</td>
</tr>
<tr>
<td></td>
<td>(b) Ensuring allocative efficiency through investment appraisal and exploration of alternatives</td>
<td>Planning, programming, budgeting systems; cost-benefit analysis</td>
</tr>
<tr>
<td></td>
<td>(c) Economic analysis of the impact of the budget</td>
<td>Various concepts and measures, ranging from structural budget margin to full employment surplus budget</td>
</tr>
<tr>
<td></td>
<td>(d) Planning over an extended period</td>
<td>Multiyear budgeting</td>
</tr>
<tr>
<td></td>
<td>(e) Policy planning with an explicit recognition of resource constraint</td>
<td>Envelope system; reconsideration procedures</td>
</tr>
<tr>
<td></td>
<td>(f) Budget planning in terms of different resource availabilities</td>
<td>Zero-base budgeting</td>
</tr>
<tr>
<td>Economic</td>
<td>(a) Flexibility in government budgets that would compensate for fluctuations in the levels of private activity and that would ensure stability in the economy</td>
<td>Increases and reductions in expenditure through ad hoc measures or institutionalized mechanisms</td>
</tr>
<tr>
<td></td>
<td>(b) Management of the economy</td>
<td>Controls on overall deficit as percentage of GDP, or on borrowing requirements</td>
</tr>
<tr>
<td></td>
<td>(c) Containment of expenditures during periods of inflation</td>
<td>Cash limits</td>
</tr>
<tr>
<td></td>
<td>(d) General restrictions on expenditures</td>
<td>Constitutional limits</td>
</tr>
</tbody>
</table>

NOTE: All the orientations, features, and techniques are somewhat related. But some techniques are more closely related to some orientations, and this aspect is illustrated above.

be considered assets of government financial management systems. To that extent, its coverage is selective. It does not aim to describe the systems, but to deal with problems that might be the agenda for government financial managers in the late 1980s and early 1990s. It seeks to be realistic, not apocalyptical. The first section sets out certain general facts and considerations relating to government finances in developing countries as a prelude to the detailed consideration of these problems. A discussion of the current status of the government financial management systems follows. Finally, the paper considers the areas that need addressing and how it may be done.
SOME FACTS AND CONSIDERATIONS

It is generally recognized that the government is the largest organization, employer, and spender in industrial and developing countries. The magnitude of its receipts and expenditures has no parallel in the private sector. More important, its operations have been growing over the last few decades. This growth is more pronounced in some countries. In a few countries, government expenditures have registered a decline as a share of gross national product (GNP). In developing countries during 1972-85, total government expenditures grew as a share of GNP by nearly 7 percent. The effect of such a growth was twofold: on the composition of expenditures and therefore on the financial management system; and on the overall pattern of government finances and thus on the economy.

In most developing countries—reflecting the larger role of the public sector—more is allotted either for direct investment or for lending and related transfers to public enterprises and other public sector entities. Growth in public spending, together with the change in composition, implies that, in considering the government financial management system, due attention has to be paid to its capability to reflect and respond to the changing requirements of the enterprises and entities dependent on public budget transfers. An associated aspect of both vertical and horizontal expansion of government activities has been a growing tendency to centralize policy and process controls.

The growth in expenditure was accompanied, in general, by a less than commensurate increase in government revenues, which in turn contributed to growing fiscal deficits. During 1972-85, developing countries’ fiscal deficits increased from 3.5 percent to 6.3 percent of GNP. As the scope for domestic financing was less in developing countries, they frequently resorted to inflationary financing and to external debt. In due course, both these policy pursuits contributed to steady and continuing fiscal crises. These crises and the approaches to minimizing and avoiding them have become dominant themes in the last few years. Since the overhang of these problems will probably continue, they will almost certainly continue to dominate the work of fiscal policymakers and government finance managers in the near future.

The fiscal crises themselves have had an enduring impact on the working of financial management systems in government. The main feature of the crises, which tended to permeate the whole process, was uncertainty—about allocation of funds, their availability, and their release. The ceilings and resource allocations indicated at the beginning of the fiscal year were adjusted downward during the year,
and cuts were frequently imposed on an ad hoc basis and across the board. In addition, restrictions were imposed on inputs, which in turn substantially affected outputs and outcomes. Also, the payment process was frequently centralized, and, as a result of restrictions on payments to conform with reduced allocations, substantial domestic and foreign arrears accrued. More significant, decision making and operational responsibilities were centralized. Furthermore, the crisis management approach was not to anticipate crises but to deal with them as they arose, and consequently the policy guidance role of central agencies suffered. Moreover, as crisis management became the prevailing style, financial management systems received either benign or deliberate neglect.

**CURRENT PROBLEMS**

Problems in government financial management have been identified from time to time. Each time, however, the problems identified were different. In the late 1930s, they were primarily in the area of budget structures (division of government outlays into current, capital, and related aspects) and in the relationships between the treasuries or ministries of finance and the spending agencies. In the 1950s, they concerned the inherited colonial administration systems and the requirements of development planning. In the 1960s, emphasis shifted to the management aspects of government finances, and problems were identified in expenditure objectives (or the lack thereof), in the relationship between policies and their financial implications and between physical and financial aspects, and in the measurement of program costs, benefits, and effectiveness. These problems continued into the 1970s and can still be found, in differing degrees. Several new budgeting systems were introduced (for example, program, performance, and planning and the selective introduction of accrual accounting), as were other systemic improvements. However, the intention here is to cover the current problems.1

These problems cover a wide area and range from public expenditure planning to government accounting and financial reporting, as well as the control of public enterprises. The main problem areas in the systems, excluding those relating to public enterprises, are illustrated in Table 2. Some of these problems are carryovers, while some have emerged as a result or as part of the fiscal crises described earlier.

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1Considerable literature on the subject exists, replete with country studies and horizontal surveys.
Table 2. Major Problems in Government Financial Management

### Public Expenditure Planning
- Absence of expenditure priorities
- Lack of link with macroeconomic framework
- Inadequate review of programs
- Absence of budgetary guidance to spending agencies
- Poor preparatory work in spending agencies
- Absence of contingency plans
- Inadequate attention to operation and maintenance, expenditures, public debt budgeting, and government lending programs
- Inadequate guidance on price factors
- Separation of personnel determination from annual budget determination
- Lack of attention to volume and productivity factors

### Resource Planning
- Absence of detailed estimates of revenues and receipts over the medium term
- Lack of convergence between resource and expenditure budgets during budget formulation

### Budget Structures
- Inconsistent practices in classifying current and capital items
- Program and object categories inconsistent with National Income Account classification
- Classification practices unsuited to management requirements
- Excessive number of extrabudgetary accounts
- Inadequate links between development plan and annual budget

### Budget Implementation
- Rigidity in release of funds
- Excessive reliance on central controls
- Inadequate financial management capability in spending agencies
- Lack of efficiency indicators
- Absence of cost data
- Poor cash management

### Government Accounting and Financial Reporting
- Absence of commitment accounting
- Extended lags in consolidation of accounts
- Difficulty in reconciling with monetary accounts
- Outdated payroll systems
- Lack of differentiated focus in fiscal reporting for policy purposes
- Long delays in submission of periodic reports

### Allocation of Expenditures
The viability of any budget depends on the information available on competing demands, costs of projects and programs, and macroeconomic linkages and implications. Although political decisions may finally be made that are contrary to economic and financial indicators, the budgetary process should be organized to generate the data needed. Recent experience has shown that governments have to some extent answered the allocation issues between public and private sectors, but have yet to achieve a balance among and within programs. This allocative balance appears to have been further
skewed in the context of crisis budgeting as a result of arbitrary limits imposed on budgetary inputs.

The process is also not generating data on the future implications of current policies, or on the operations and expenditures needed to maintain completed projects. Decisions are therefore piecemeal, some as part of the formal budget and some outside the process and the budget. Also, the revenue and expenditure budgets lack congruence, which frequently contributes to situations in which outlays are determined without reference to resources available. As a result, there has been a shift from the strategic management of the budget to tactical approaches that imply changes in policy posture.

Uncertainty

As a result of economic uncertainty and the lack of ability of systems to reckon with it, budgets considered to be policy instruments and embodiments of programs of action were submitted much too late in the fiscal year. Instead of promoting a coherent strategy, they were put together in a hurry and more as a ritual, with more prayer than reason. Also, budgets submitted so late engendered uncertainty within the spending departments and in the economy at large. Sometimes, no budgets were submitted, and the previous year’s budget became, by default, the budget for the current year.

Budget Structure

Budget structures, which were often reorganized to conform to program budgeting tenets and to promote a management bias in government, became outmoded, owing to the lack of a periodic update and to the rapid changes in government policies and activities.

Budget Implementation

Budget implementation suffered heavily, as did budget preparation and submission. Frequently, midstream changes in allocations exacerbated the uncertainty and contributed to a rush of expenditures and to excess expenditures in several areas. Indeed, the atmosphere encouraged the perverse idea that spending agencies were better off using their allocations regardless of the results, because they constituted legitimate claims for further allocations in subsequent years.

Accounting System

Accounting systems remained largely unresponsive to efforts to improve them. Little or no discernible progress was made in the
measurement of costs. Fiscal reporting continued to be incomplete, lacking in purpose, and frequently delayed. Moreover, above- and below-the-line items of a budget were not reconciled. Instead of facilitating forecasting of cash requirements and debt management coordination, cash management became a negative process intended primarily to curtail payments. Even the conventional wisdom that accounting facilitates legislative accountability became debatable, as the accounting systems that continued to employ large numbers of people provided neither comprehensive nor timely data.

Financial Management

Financial management was dominated by central controls that were excessively process oriented. Effective communication between the central and the spending agencies about resource realities was lacking. Centralization, while contributing to an avoidable abuse of power and to trivializing controls, imposed an additional strain on the process and on policymakers. More important, it contributed to a loss of financial consciousness in the spending agencies. As the types and instruments of control increased, efforts to control waste and abuse of authority became diffuse and lacked accountability. Procedures and rules were frequently perverse and overwhelmed substance. Control became more important than achievement, resulting in managers’ losing their sense of relevance and control.

While the preceding discussion underlines the pervasiveness of the problems and the need for improvement, the issue of why these problems accumulated, despite a continuing effort to improve government financial management systems, remains. The answers vary among countries, depending on the specific factors in each case. Some common factors, however, can be identified. To a large extent, the major contributing factor was the absence of a strategy for reform that took into account the requirements of a system. Too often, each reform introduced in industrial countries was replicated without the unique features of the local system being taken into account. As the link between innovation and expected outcome was quite unclear, disillusionment quickly set in, the traditional organizational inertia contributed to a widespread sense of defeatism, and instead of determination and perseverance, a sense of despair prevailed. It was easier to seek alibis than to evaluate the causes. The situational factors also somewhat impeded the progress that could otherwise have been made. The changing economic context, particularly the magnitude of fiscal deficits, undoubtedly had an adverse impact. Time and again the extended lag between the recognition of a problem and the formulation of a strategy was demonstrated. In short, even when efforts to improve the system were made, they were too few and too late.
PROGNOSIS

Such a situation elicits two responses: a continuation of the current approaches or a firm determination to resolve it. The economic imperatives are such that the former would have little support. Indeed, the experience of the last five years shows greater ingenuity, not in terms of designing new systems but in terms of packaging the different elements into a practical strategy. Developing countries have little option but to take into account the severity of the problems described above, consolidate their few gains, and formulate strategies that reflect local needs and capabilities. In formulating these strategies two major premises must be recognized: (a) large organizations take time to reorient themselves to new systems and techniques; and (b) large organizations can perform only a few tasks at a time. Within these parameters, developing countries have to make choices about the systems available, the relevance of these systems to their situations, and implementation strategies. Their efforts need assistance from international organizations. The role of national organizations and the priorities for improvements are discussed below.

RECENT IMPROVEMENTS AND THEIR RELEVANCE FOR DEVELOPING COUNTRIES

Whereas the 1950s and the 1960s witnessed major innovations in financial management in terms of new systems to measure performance and to improve allocative mechanisms, recent improvements have been selective and have consisted of extending or refining the application of previous concepts. Table 3 summarizes these improvements. In applying them to developing countries, three major elements and a vital but supporting element need to be stressed.

The improvements should aim at (1) forging stronger links between the strategic planning system, the budgeting and cash planning, and the control systems; (2) strengthening links between inputs and outputs; and (3) reconciling the interests of aggregate policy management and the disaggregated interests of managers.

The senior managements of both the central and the spending agencies should commit themselves to implementing the improvements. This implementation will involve reforming the institutional, systemic, and technical aspects of financial management.

In the institutional area, immediate efforts are needed to improve the balance between the central and the spending agencies. Although several factors emphasize the general need for improved balance, three are particularly urgent. First, excessive centralization during periods of economic crisis has had the unintended effect of reducing financial consciousness in spending agencies and encouraging need-
Table 3. Recent Improvements in Government Financial Management

<table>
<thead>
<tr>
<th>Broad Area</th>
<th>Systems and Techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy planning</td>
<td>(a) Explicit recognition of resource realities</td>
</tr>
<tr>
<td></td>
<td>(1) Envelope or portfolio budgeting</td>
</tr>
<tr>
<td></td>
<td>(2) External legislative or constitutional limits</td>
</tr>
<tr>
<td></td>
<td>(b) Resource planning and utilization</td>
</tr>
<tr>
<td></td>
<td>(1) Global targets or ceilings on revenues, outlays, and deficits</td>
</tr>
<tr>
<td></td>
<td>(2) Improved planning of impact of cuts in expenditure</td>
</tr>
<tr>
<td></td>
<td>(3) Contingency planning</td>
</tr>
<tr>
<td>Budget systems</td>
<td>(a) Multiyear expenditure planning</td>
</tr>
<tr>
<td></td>
<td>(b) Formulation of “core” and “noncore” budgets</td>
</tr>
<tr>
<td></td>
<td>(c) Scrutinies and reviews</td>
</tr>
<tr>
<td></td>
<td>(d) Improved budget guidance</td>
</tr>
<tr>
<td></td>
<td>(e) Efficiency controls</td>
</tr>
<tr>
<td>Organization improvements</td>
<td>(a) Improved balance between central and spending agencies</td>
</tr>
<tr>
<td></td>
<td>through delegation of enhanced powers and responsibilities</td>
</tr>
<tr>
<td></td>
<td>(b) Improved fiscal reporting</td>
</tr>
<tr>
<td>Budget implementation</td>
<td>(a) Cash management system</td>
</tr>
<tr>
<td></td>
<td>(b) Cost measurement</td>
</tr>
<tr>
<td></td>
<td>(c) Improved evaluation</td>
</tr>
</tbody>
</table>

Less dependence on central agencies. Governments have grown so large that central commands have neither a uniform nor a desired effect. The realities of modern organization are such that more powers and tasks need to be decentralized if policy and financial considerations are to be integrated. Second, the emphasis from the community’s point of view is going to be on the delivery of timely, courteous, and efficient services, which in turn underlines the need for greater decentralization. Third, the spending agencies have to be made accountable for results, and appropriate devices such as the contract programs recently adapted in public enterprises need to be devised for them. Agencies can only be expected to manage their affairs if they are permitted to be managers.

In the systemic area, greater emphasis is needed on policy planning that would facilitate a more precise identification of the financial implications of current policies and their macroeconomic linkages. Although some countries have introduced multiyear expenditure planning, they have not become fully operational, and technical improvements are often indicated. In particular, it is necessary to ensure a periodic convergence between resource and expenditure budgets and to introduce planning reserves to meet unforeseen contingencies. Similarly, more effort is indicated in measuring costs and in preparing profiles of running costs for current programs. These
efforts have to be accompanied by improvements in applying evaluation techniques. Together, these improvements will strengthen the budgetary process.

In the technical area, it is of the utmost importance that accounting systems are reviewed and made more functional in their orientation. Even the introduction of electronic data processing technology has yielded only moderate results, as the systemic deficiencies have remained unaddressed. The systems should be re-evaluated now to provide timely data. Similarly, the coverage of the budget should be reviewed to find out whether the creation of numerous extrabudgetary funds has effectively reduced its function as a policy instrument. As an integral part of this effort, tax expenditures need to be identified and budgetary presentation improved to achieve greater transparency of government transactions.

Another area that continues to be of vital importance is the development of human resources. No institutional and systemic development can be sustained without adequate support from the human element. As emphasis in financial management shifts from accounting of moneys spent or raised to accountability for results and for delivery of results, more tasks will devolve on the personnel concerned. In the past, the lack of properly trained staff, despite several notable training programs to enhance technical skills, was a major handicap. To perform new tasks with improved productivity in the public sector requires that more efforts be devoted to human resource development.

**ROLE OF NATIONAL AUTHORITIES**

Improvement of institutions, as past experience conclusively demonstrates, is a long-term process more suited to long-distance runners than sprinters. A fourfold approach would be appropriate: (1) an effort should be initiated to review the problems of the institutions and to identify the core problems to be attacked; (2) once these problems are identified, governments should formulate strategies to solve them, which should take into account the priorities as well as the local institutional realities; (3) greater effort should be devoted to the phasing of the implementation of the strategy after taking into account the human and financial aspects as well as the linkages among different elements of the strategy; and (4) the authorities should identify those areas that can be undertaken from their own resources and those that require external aid.
Why the Deficit Persists as a Budget Problem: Role of Political Institutions

ALLEN SCHICK

Most democratic countries entered the 1980s with their public finances in disarray. Two oil shocks, low growth, high inflation, and high unemployment had destabilized the postwar relationship between the economy and the budget and had left large, seemingly intractable deficits. As the 1980s draw to a close, the fiscal pattern appears to be more favorable and more varied. Almost all industrialized democracies now have deficits well below the peaks experienced earlier in the decade, and a few have run budget (or public sector) surpluses in the last year or two. In contrast to the despair and confusion that beset democratic governments at the start of the decade, there is today widespread—not universal—confidence that both national economies and budgets can be stabilized.

This paper takes the position that the accolades and self-confidence may be premature. The turnaround in public finance has been accomplished during a period of sustained economic growth. The true test of fiscal balance will come when the economies of industrialized democracies undergo cyclical weakness. The concern that deficits persist as a budget problem is predicated on the notion that fiscal stability depends as much on political actions as it does on economic conditions. To illustrate this point, I will review an extreme case: the deficit trend in the U.S. Government. My selection of the United States is based on two considerations: first, I am more familiar with its budget policy than with the policies undertaken in other countries; second, the United States is a country whose deficit-reduction objectives have been impeded by peculiar governing arrangements, in particular the division of power between the legislative and the executive branches. As such, the U.S. Government is an atypical but informative case study of the role of political institutions in setting and implementing fiscal policy.
FISCAL POLICY: FROM KEYNESIAN EXPANSION TO FISCAL RESTRAINT

The first oil shock in 1973–74 transformed budgeting in industrialized democracies from an engine of government expansion into a process for restraining growth in the public sector. The postwar era was characterized by high economic growth, widespread improvements in productivity and the overall standard of living, and low rates of inflation and unemployment. Economic expansion begot incremental budgeting, which concentrated governmental attention and policy decisions on the size and allocation of spending increases. Although public sector growth generally outpaced the trend in the economy, it was deemed appropriate during the expansive postwar years to allot a rising share of national output to public programs. Accordingly, total government outlays in the Organization for Economic Cooperation and Development (OECD) community averaged about 35 percent of GDP in 1974, compared with only 28 percent in 1960. One reason for this progressive enlargement in the relative size of the public sector was that fiscal policy was geared to the potential of the economy, and it seemed proper that the public share rise (because of built-in stabilizers and discretionary stimulus) during cyclical bouts of weakness. Actual budgetary balance was abandoned as an operative norm in most OECD countries, as it was deemed more important to balance the economy than to balance the budget. Nevertheless, economic vigor ensured that deficits (when they occurred) were modest and manageable.

Economic growth was accompanied by political stability. Even in countries (such as Italy) in which elections and government turnover were frequent, policies remained in place for extended periods. A broad consensus on the role of government in combating unemployment and in ameliorating the financial distress of old age, disability, unemployment, and other obstacles to productive labor led to increased social expenditure and to steep escalation in transfer payments. As governments became more confident of their capacity to sustain economic well-being and promote the public welfare, their budgetary machinery was oriented from spending control to program expansion. Program budgeting and multiyear analysis—two prominent postwar innovations—were not simply rearrangements in budgetary technique; rather they were adaptations to the realpolitik of government expansion. Multiyear budgeting enabled governments to plan for long-term growth; program budgeting enabled them to select the policy initiatives that would do the most good.

Economic and political stability was jarred, however, by the first oil crisis, which brought in its wake stagnation, soaring inflation, and unemployment, and a slowdown (or halt, in some countries) in the
productivity gains that had previously made it possible for both public expenditure and private disposable incomes to rise. Some industrialized countries responded to the first oil shock as if it was a conventional cyclical downturn. They tried to reflate their economies through job-creation schemes and tax relief, and they accepted the upsurge in deficits as the normal countercyclical response. But recovery generally was short-lived and sluggish. Caught in the grip of stagflation, various governments found that policies aimed at combating unemployment worsened inflation and added to the budget deficit without accomplishing their objectives. They came to see high unemployment as a structural problem that could not be significantly remedied through short-term interventions.

In a weakened economic condition, most OECD countries concluded that they could not close their budget deficits through tax increases. But they recognized that unless they changed course, the weight of past decisions—such as indexed transfer payments and other commitments—would compel high and chronic deficits and would impel continued enlargement in the relative size of the public sector. Owing to widespread entitlements, public sector prices rose at a faster rate than the general price level (Baumol’s relative price effect); owing to demographic trends, the public sector would continue to expand relative to the overall economy, even if no new programs were initiated.

This realization began to solidify into government policy in the late 1970s when the second oil shock unsettled national economies. Still reeling from the aftereffects of the previous tremor only five years earlier, industrialized countries quickly came to the conclusion that they could not respond this time with textbook countercyclical prescriptions. Instead, they began to shift gears from incremental to decremental behavior. This shift in budgetary and fiscal orientation had a number of characteristics: (1) the establishment of cutback norms and guidelines; (2) the separation of budgetary and economic policy; and (3) the translation of cutback norms into operational budget objectives.

NORMS AND GUIDELINES FOR FISCAL RESTRAINT

Canada was one of the first developed countries officially to adopt constrictive budget norms. Its 1975 White Paper, "Attack on Inflation," declared that "The federal government shares the view that the trend of total spending by all governments in Canada should not rise more quickly than the trend of the gross national product." It is important to note that the stated objective was to stabilize—not to reduce—the relative size of the public sector. In Canada, as in other
industrialized countries, it was feared that without new restraints, the public sector would continue to expand its share in GNP, causing either a progressive rise in tax burdens or a chronic budget deficit.

To avert this undesired state of affairs, many OECD countries moved in the late 1970s or early 1980s to policies that, they hoped, would restore budgetary balance by moderating the rise in expenditure while lowering or stabilizing the tax burden. In the Netherlands, this policy shift meant abandonment of the structural budget norm that had guided fiscal policy during most of the postwar period. This norm pegged public expenditure to the potential of the economy; in application, it permitted a steady rise in the relative size of the public sector. In the 1970s, however, the utility of this norm was vitiated by actual deficits that were almost double the amount allowed by the structural policy. As a consequence, late in the decade, the Government shifted to a fiscal rule predicated on expected performance of the economy rather than on structural capacity. Moreover, to reduce the deficit and stabilize the collective burden, it adopted a policy that would have limited the annual rise in public expenditure to no more than 1 percent of net national income (NNI). But inasmuch as this norm would have permitted continued enlargement of the public sector’s share in GNP, within a few years it was discarded in favor of a rule that permitted no rise in the expenditure/NNI ratio.

While the targeting of fiscal objectives was an exceptional practice a decade ago, it is today conventional practice. Thus, a 1987 OECD report, *The Control and Management of Government Expenditure*, noted

The last ten years may be summarised as the decade when "top-down" constraints were gradually imposed much more effectively on the "bottom-up" demands of spenders, their clients and supporters. . . . All countries taking part in the study now publish some form of summary objectives or targets for fiscal policy. These usually include a target for expenditure. Many governments publish their budgetary targets to stimulate public discussion. Often this is seen as a way to further build consensus about fiscal policy goals and means to meet them. (p. 21)

As the OECD report noted, in virtually all of its member countries, budgetary objectives are expressed in quantitative terms for a number of years ahead. These specific targets are intended to provide a strong message, especially to spending agencies and interest groups, concerning the government’s fiscal objectives and its determination to implement them.

Contemporary fiscal norms come in many varieties, but they can be classified into three main forms: (1) a relative standard in which one or more of the fiscal aggregates (total revenue, outlays, deficit, or the public debt) is to be stabilized or reduced relative to GNP or some other measure of economic activity; (2) a standard pertaining to the
rate of change in spending or another fiscal aggregate, such as a rule prescribing zero real growth in spending or a decline in the budget deficit; and (3) an absolute value for the fiscal aggregate to be achieved at some time in the future, such as a rule that the deficit two years hence shall not exceed some stated amount.

Some examples drawn from published and unpublished OECD material will illustrate how these norms have been applied in practice. The following paragraphs review the fiscal norms embraced in the major OECD countries.

Australia. In 1985, the Federal Government adopted a medium-term strategy to stabilize outlays, revenue, and the deficit as a proportion of GDP. This "trilogy" policy was subsequently modified by a commitment to reduce the size of the deficit in nominal terms.

Canada. The fiscal target established in the 1975 White Paper was refined in the next decade to curtail the growth in public expenditure so that it would decline relative to GNP. To accomplish this, the Government recognized, would require the year-to-year growth in expenditure to be below the rate of inflation. If this were accomplished, it was expected that the debt/GNP ratio would decline to a more acceptable level.

Denmark. A strategy calling for zero real growth in public expenditure and the gradual elimination of the deficit was adopted in the early 1980s.

France. Following a brief period of expansion when the Mitterand Government took office, the Government made a "U-turn" and moved to a more restrictive posture. By the mid-1980s, preparation of the national budget was guided by two principal constraints: that the central government deficit not exceed 3 percent of GDP and that the tax burden be lowered by 1 percent a year.

Federal Republic of Germany. Throughout the 1980s, formulation of the federal budget was influenced by efforts to curtail the deficit, restrict the growth in expenditure to approximately the growth rate of GDP, and restrain public consumption while increasing investment-related expenditure. The 1984 medium-term financial plan was based on a "consolidation strategy" that would restrict the growth of federal expenditures to 3 percent a year in current prices and cut net borrowing in half.

Italy. Owing to the massive public deficit, emphasis was placed on stabilizing the public sector borrowing requirement (PSBR) that covers all levels of governments. However, the PSBR often overran its target in the 1980s, forcing frequent adjustments in this fiscal norm.

Japan. The 1982 report of the Administrative Reform Commission urged that the ratio of general expenditure to GNP (excluding interest payments) be stabilized. The Commission noted that although the tax burden would have to rise, it should be kept much lower than that of

Sweden. With central government budget deficits exceeding 10 percent of GNP, the Government adopted a medium-term strategy in 1984 to reduce the deficit to no more than 4-5 percent by the end of the decade while keeping the tax/GNP ratio approximately constant. This norm implied a reduction in public expenditure relative to GNP.

United Kingdom. In the 1980s, the medium-term financial strategy, which accompanies the annual budget, has established objectives for the PSBR. The PSBR covers central government, local authorities, and the net lending of public enterprises. In general, the medium-term financial strategy indicated a PSBR that declined from more than 5 percent of GDP at the start of the decade to only 2 percent in 1985/86.

DIVORCING BUDGET AND ECONOMIC POLICY

The policy norms outlined in the preceding paragraphs represent much more than a determination to stabilize or reduce public expenditure and the deficit. They also reflect a fundamental reorientation in the budget’s role in economic policy. In lieu of the use of the budget to steer the economy as was paramount during postwar Keynesianism, the budget reverted in the 1980s to its old-fashioned task of balancing revenues and expenditures and determining the amounts to be spent by public programs and agencies. This reorientation has inevitably meant less attention to active fiscal policy as a means of influencing short-term economic conditions. Part of the reason for deemphasizing short-term results is that the large automatic component in the budget (principally, mandatory transfer payments) makes it exceedingly difficult to adjust budget policy to cyclical swings in the economy.

Governments in the 1980s lost confidence in interventionist fiscal policy. The prevailing attitude came to be that the national budget cannot effectively remedy economic ills unless it is first restored to health, that is, unless the deficit and expenditure growth are reduced to more acceptable levels. Budget norms have thus become more insular and limited: the primary objective of the budget process should be to manage expenditures within fixed targets. Of course, both revenue and expenditure remain highly sensitive to changes in economic conditions; hence, contemporary governments cannot be completely indifferent to the impacts of their budget actions on the economy.

It should be noted that targets infiltrated monetary policy some years before they became common in fiscal policy, but that the mo-
tives were similar. In both developments there was a pervasive belief that governments and politicians could no longer be left to their own discretion, either because they lacked sufficient information with which to intervene in an effective manner, or because they could not be trusted to do the right thing. In the absence of fixed targets, they would respond to political crisis by easing fiscal policy or inflating the money supply. They could not be relied on to do the right thing when tough action was called for.

The shift to budget targets was accompanied by a recognition that today’s cyclical crisis is tomorrow’s structural difficulty. That is, it was recognized that the deficits incurred in response to cyclical weakness add to the future debt burden, and hence to future interest charges. As these charges became an increasingly prominent portion of public expenditure in the late 1970s and early 1980s, industrialized democracies turned away from short-term policies to longer-term concerns.

As budgeting became more oriented to spending control, it gave more attention to the actual (or expected) performance of the economy, rather than to its potential. Performance was more important than potential because the key budgetary objective was to curtail the deficit and expenditures relative to GNP.

**TRANSLATING THE FISCAL NORMS INTO BUDGET POLICY**

Budgetary norms are effective only to the extent they influence financial decisions. When governments seek restraint, they must translate these policies into concrete actions, and they must be able to assess particular decisions in the light of their budgetary objectives.

Table 1 indicates that few industrialized democracies have succeeded in stabilizing public expenditure. The data reveal that only 2

<table>
<thead>
<tr>
<th>Country</th>
<th>1980</th>
<th>1987</th>
<th>Increase (or Decrease) in Outlays as Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>34.0</td>
<td>38.3</td>
<td>4.3</td>
</tr>
<tr>
<td>Canada</td>
<td>40.5</td>
<td>45.6</td>
<td>5.1</td>
</tr>
<tr>
<td>Denmark</td>
<td>56.2</td>
<td>58.3</td>
<td>2.1</td>
</tr>
<tr>
<td>France</td>
<td>46.1</td>
<td>58.3</td>
<td>5.7</td>
</tr>
<tr>
<td>Germany, Fed. Rep. of</td>
<td>48.3</td>
<td>46.8</td>
<td>(1.5)</td>
</tr>
<tr>
<td>Italy</td>
<td>41.9</td>
<td>50.7</td>
<td>8.8</td>
</tr>
<tr>
<td>Japan</td>
<td>32.6</td>
<td>33.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>57.5</td>
<td>60.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Norway</td>
<td>48.3</td>
<td>51.6</td>
<td>3.3</td>
</tr>
<tr>
<td>Sweden</td>
<td>61.6</td>
<td>59.9</td>
<td>(1.7)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>44.9</td>
<td>45.9</td>
<td>1.0</td>
</tr>
<tr>
<td>United States</td>
<td>33.7</td>
<td>36.7</td>
<td>3.0</td>
</tr>
</tbody>
</table>

1987 figures not available; 1986 figures used instead.
of the 12 countries shown had lower relative expenditures in 1987 than in 1980. The two success stories were Germany and Sweden, and each had a special explanation of its performance. Germany's historic apprehension about the resurgence of inflation led it to adopt more austere policies than were acceptable in other countries; Sweden's status as the country with the highest tax burden and the largest public sector led it to recognize that the incessant rise in public spending must be contained.

Despite the general lack of success in curbing public expenditure, half of the OECD countries now have smaller budget deficits than they had at the beginning of the decade. Table 2 shows that 3 of the countries had budget surpluses in the most recent year for which data are available, 4 had smaller deficits, and 5 had bigger deficits. The trend in government receipts explains how some countries have managed to curtail their deficits without taking strong steps to retrench public expenditure. All but one of the major OECD countries had higher current receipts (relative to GNP) in the most recent year than they did in 1980. In other words, pressure to trim the deficit has led to an updrift in government receipts, either through specific policy actions such as tax increases or by allowing economic expansion, inflation, or other factors to generate higher tax burdens.

The plain fact is that industrialized democracies have not done very much to curb the upward spiral in public expenditure. Most have squeezed public consumption and investment (the two principal categories of discretionary expenditure), but they have not been willing to challenge the built-in entitlements that mandate higher expenditures.

Table 2. General Government Financial Balances  
(Surplus (+) or Deficit (-) as Percentage of Nominal GNP/GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>1980</th>
<th>1987</th>
<th>Increase (or Decrease) in Financial Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>-1.6</td>
<td>-0.6</td>
<td>1.0</td>
</tr>
<tr>
<td>Canada</td>
<td>-2.8</td>
<td>-4.6</td>
<td>-1.8 (1.8)</td>
</tr>
<tr>
<td>Denmark</td>
<td>-3.3</td>
<td>+2.0</td>
<td>5.3</td>
</tr>
<tr>
<td>France</td>
<td>-0.1</td>
<td>-2.0</td>
<td>-1.9 (1.9)</td>
</tr>
<tr>
<td>Germany, Fed. Rep. of</td>
<td>-2.9</td>
<td>-1.8</td>
<td>1.1</td>
</tr>
<tr>
<td>Italy</td>
<td>-8.5</td>
<td>-10.5</td>
<td>-2.0 (2.0)</td>
</tr>
<tr>
<td>Japan</td>
<td>-4.4</td>
<td>+0.6</td>
<td>5.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>-4.0</td>
<td>-6.1</td>
<td>-2.1 (2.1)</td>
</tr>
<tr>
<td>Norway</td>
<td>+5.7</td>
<td>+4.6</td>
<td>-1.1 (1.1)</td>
</tr>
<tr>
<td>Sweden</td>
<td>-2.8</td>
<td>-2.2</td>
<td>0.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-3.4</td>
<td>-1.5</td>
<td>1.9</td>
</tr>
<tr>
<td>United States</td>
<td>-1.3</td>
<td>-2.3</td>
<td>-1.0 (1.0)</td>
</tr>
</tbody>
</table>

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for pensions, health care, and other transfer payments. Some countries have trimmed these payments at the margins, but they have not been able to launch a frontal attack on the welfare state.

The slowdown in the growth of spending relative to GNP has occurred during an extended period of economic expansion. While economic growth has been somewhat less vigorous in the 1980s than in previous decades, it nevertheless has channeled more resources to government treasuries and has enabled them to moderate public expenditure without making severe cutbacks.

Do the actions taken thus far in the 1980s suffice to arrest the progressive rise in public spending and the deficit problem? The title of this paper suggests that the answer is no. In view of the failure of democratic governments to restructure the demands on their budgets, one should not be surprised if big deficits recur the next time the economy turns downward. Moreover, the deficit problem is likely to worsen over time, as populations age, health care costs soar, and other demands on the public purse persist.

The failure to rein in public expenditure is primarily a political—not an economic—problem. Cutting expenditures means trimming services, taking away benefits, curtailing rights to payments, and allocating losses. None of these are easy for democratic politicians to do. An OECD study of 11 macroeconomic interventions, *Why Economic Policies Change Course*, concluded that political leaders did "not seriously tackle the root causes of their problems until the situation approached crisis conditions and the need for remedial action, on the internal as well as on the external side, became evident and broadly accepted by . . . the population at large." (p. 9). In short, only when the existing course of action became "unsustainable" did democratic governments, reluctantly and with a lot of foot-dragging, alter course.

One of the lessons of the 1980s is that failure to achieve fiscal norms is not sufficient cause for altering policy, nor is the persistence of budget deficits or the continuing upward creep in public expenditure relative to GNP.

**PATHOLOGY OF DEFICIT BUDGETING IN THE UNITED STATES**

The budget deficit has dominated national politics in the United States throughout the 1980s. During the 1980 presidential campaign, then-candidate Ronald Reagan announced a target of far lower taxes and spending relative to GNP and a balanced budget by 1984. He reaffirmed these objectives in an economic program presented shortly after taking office. However, it proved much easier to reduce taxes
than to curtail spending or the deficit. Table 3 shows the trend in the budget deficit, in nominal terms and relative to GNP during the 1980s.

The failure to control the deficit has spawned a lively debate concerning the true objectives of President Reagan. Some say that he wanted high deficits as a means of constraining public expenditures; others argue, however, that the President accepted deficits as a necessary evil only when he realized the high cost of eradicating them. A plausible view is that while the White House did not engineer the deficit, it exploited this condition once it became entrenched. President Reagan clearly preferred a smaller government with a bigger deficit than a bigger government with a smaller deficit. To him, this trade-off was inevitable, for he firmly believed that any tax increase legislated to ameliorate the deficit would lead instead to higher spending.

Regardless of the President's motives, protracted conflict with Congress precluded decisive action on the deficit. Through the 1980s, the United States had divided government, not only in the sense that the Republicans controlled the presidency and the Democrats controlled one or both houses of Congress, but also in the sense that the two branches warred over budget policies and priorities. The President was determined to downsize domestic government, but after initial success in 1981, he faced a Congress determined to maintain social programs against presidential attack. The result was a protracted impasse, with Congress unable to get the President to agree to sizable tax increases (though he signed a series of modest increases during 1982-87) and the President unable to get congressional approval of further cuts in domestic spending.

As the impasse persisted, the deficit worsened, peaking at $221 billion during the 1986 fiscal year. This condition led to enactment of

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>GNP</th>
<th>Deficit</th>
<th>Deficit as a Percentage of GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>2,670.6</td>
<td>-73.8</td>
<td>-2.8</td>
</tr>
<tr>
<td>1981</td>
<td>2,986.4</td>
<td>-78.9</td>
<td>-2.6</td>
</tr>
<tr>
<td>1982</td>
<td>3,139.1</td>
<td>-127.9</td>
<td>-4.1</td>
</tr>
<tr>
<td>1983</td>
<td>3,321.9</td>
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</tr>
<tr>
<td>1984</td>
<td>3,687.7</td>
<td>-185.3</td>
<td>-5.0</td>
</tr>
<tr>
<td>1985</td>
<td>3,952.4</td>
<td>-212.3</td>
<td>-5.4</td>
</tr>
<tr>
<td>1986</td>
<td>4,186.8</td>
<td>-221.2</td>
<td>-5.3</td>
</tr>
<tr>
<td>1987</td>
<td>4,433.8</td>
<td>-149.7</td>
<td>-3.4</td>
</tr>
<tr>
<td>1988</td>
<td>4,780.0</td>
<td>-155.1</td>
<td>-3.2</td>
</tr>
<tr>
<td>1989 (estimate)</td>
<td>5,119.7</td>
<td>-161.5</td>
<td>-3.2</td>
</tr>
</tbody>
</table>
the Gramm-Rudman-Hollings law (GRH), a measure that promised to restore budgetary balance through annual deficit targets. If the estimated deficit exceeded the target, funds would be automatically canceled from both defense and domestic programs through a process known as sequestration. Inasmuch as the cutbacks would be automatic, they would occur without the consent of politicians and even if the President and Congress could not agree on their composition.

At least this was the expectation. In practice, it has not quite turned out this way, and in each of the years that the GRH process has been in effect, the actual deficit has exceeded the targeted deficit. In fact, the gap between performance and promise became so wide that it was necessary in 1987, as Table 4 shows, to stretch out the targets and lower the amount of deficit reduction that had to be achieved each year. During the 1986-89 fiscal years, the actual deficit has totaled some $230 billion more than the amount allowed in the original GRH law.

Why has a process established to eradicate the deficit allowed it to persist? Supporters of the GRH process, and there are many in Congress, insist that although the deficit targets have not been met, there has been a pronounced slowdown in the growth of federal spending and the deficit is smaller than it would have been in the absence of the GRH controls. Some comfort can be taken from the fact that relative to GNP, the deficit now is only about half the size it was in 1983 when it reached a peacetime record of 6.3 percent of GNP.

This modest success notwithstanding, this writer is of the view that GRH has not brought much deficit reduction but has encouraged a great deal of deception about the budget. The budget deficit for the most recently completed fiscal year (1989) indicates that it was above $150 billion. As shown in Table 4, this figure is above the GRH target

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Original Target</th>
<th>Revised Target</th>
<th>Actual Deficit</th>
</tr>
</thead>
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<td>171.9</td>
<td>144.0</td>
<td>221.2</td>
</tr>
<tr>
<td>1987</td>
<td>144.0</td>
<td>144.0</td>
<td>149.7</td>
</tr>
<tr>
<td>1988</td>
<td>108.0</td>
<td>144.0</td>
<td>155.1</td>
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<tr>
<td>1989</td>
<td>72.0</td>
<td>136.0</td>
<td>152.0¹</td>
</tr>
<tr>
<td>1990</td>
<td>36.0</td>
<td>100.0</td>
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<td>1991</td>
<td></td>
<td>64.0</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td></td>
<td>28.0</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹Estimated.
for the fiscal year but almost $70 billion below the peak reached three years earlier. While this may seem to be a considerable accomplishment, it is quite modest when two factors—the sustained economic expansion and the enormous buildup in social security reserves—are taken into account. It is astounding how difficult it has been to make inroads into the deficit during the longest peacetime expansion in U.S. history. When Gramm-Rudman-Hollings was enacted in 1985, the United States had just commenced the fourth consecutive year of growth; now, the economy is about to start the eighth consecutive year of uninterrupted expansion. Nevertheless, the deficit is still very large in nominal terms and relative to GNP. In the past, there was a simple and reliable correlation between the performance of the economy and the trend in the deficit. Recovery almost always brought quick and substantial curtailment of the deficit. For example, the budget deficit receded from 4.3 percent of GNP during the recession year of 1976 to only 1.6 percent during the 1979 fiscal year, a decline of almost two thirds relative to GNP. In dollar terms, the deficit declined from $74 billion to $40 billion, a reduction of almost 50 percent. During the current expansion, by comparison, the deficit has dropped from 5.3 percent of GNP in fiscal 1986 (the first GRH year) to approximately 3.3 percent in the 1989 fiscal year. This indicates, both relative to GNP and in absolute terms, that the percentage drop in the deficit was greater before the Government was armed with GRH controls than it was afterward.

The record looks even worse when social security is taken into consideration. Fully two thirds of the abatement in the budget deficit has been due to a buildup in social security reserves. The social security funds (which are excluded from the budget except for computation of the GRH deficit) had an annual surplus of less than $17 billion in fiscal 1986; during the 1989 fiscal year, the annual surplus was about $55 billion. In other words, without the offset from the social security funds, the federal deficit would still be above the $200 billion mark, not much less than it was before GRH.

Why hasn’t GRH brought much amelioration of the deficit? On its face, GRH seems to be the right prescription: a precise fiscal norm coupled with tough enforcement procedures. Cuts are automatic if the projected deficit exceeds the target, and the law spells out detailed rules as to how the calculations are to be made. Nevertheless, certain features of GRH have thwarted the capacity of the Government to deal effectively with the problem.

The bill of particulars against GRH includes the incentive it gives harassed politicians to manipulate budget data and to exploit the process to their advantage. Beyond this, GRH is a weak deficit-reduction process because it shortens the time horizon of budgeting,
induces budget officials to take timid steps and places more substantial improvement beyond reach, encourages the President and congressional leaders to conspire to avoid sequestration, and provides incentives to shift deficit-increasing actions to future budgets. Collectively, these shortcomings have turned a deficit-reduction law into a deficit-protection act. Let us consider these problems and their impact on the budget.

**GRH promotes deceptive budget practices.** Deception is not a newcomer to government budgeting, but nowadays it is practiced on a scale and with a brazenness that was unthinkable a few years ago. As recently as the mid-1980s, budgetary legerdemain was only a small part of each year’s deficit-reduction package. Perhaps four or five dollars of genuine spending cutbacks and/or revenue increases were achieved for each dollar of faked savings. At the time, the tricks were seen as an appropriate price to pay for coming to grips with the deficit. Now, however, the ratio has been reversed, and the gimmicks far outweigh the legitimate savings. Rather than easing the path to deficit reduction, budget tricks have become a substitute for them.

This pattern suggests that key participants in the budget process have learned how to exploit the GRH rules to their advantage. Ironically, despite the consistent failure to meet the deficit targets, neither the President nor Congress wants to repeal this legislation. Politicians like GRH because it conveys the impression that the Government is taking decisive action to deal with the deficit. Fortunately for them, however, GRH has not yet required that they do very much.

**GRH has shortened the time horizon of budgeting.** On paper, GRH is a multiyear process for eliminating the deficit. In practice, it is a one-year-at-a-time process that impels politicians to narrow their attention to the year immediately ahead. All that matters for them is whether the threatened sequester will be implemented. Anything that averts a sequester is welcomed, even if it worsens future deficits. As each budget cycle begins, politicians compute (using highly questionable assumptions) the amount by which the deficit has to be curtailed in order to put off the day of reckoning. If the “excess” deficit is projected to $20 billion, this is the number targeted in negotiations between Congress and the President. No one cares whether it is the right number for the economy, only that it be achieved.

**GRH encourages timid actions.** For the reason just mentioned, GRH limits the amount of deficit reduction sought each year. Imagine a world without GRH in which an embattled government was pressured to come to grips with the deficit. Instead of settling for $10–20 billion in contrived cuts (an amount equal to less than 1 percent of combined revenue and expenditure), politicians might be spurred to take truly effective action.
A look at the GRH targets for future years (see Table 4) suggests that more forceful action may be necessary to avert future sequesters. More total deficit reduction is called for in the 1991-93 fiscal years than was achieved in the previous five years. Perhaps the United States is on the brink of substantial abatement in the deficit. But it is also possible that the targets will be diluted or suspended if achieving them becomes too onerous.

*GRH encourages the President and Congress to conspire to avoid a sequester.* Nowadays budgeting operates according to a simple rule: anything is true if the President and Congress say it is. For example, if the President and Congress claim that the deficit has been reduced some $2 billion by removing the Postal Service from the budget, then $2 billion has been saved. GRH invites this type of conspiracy because of the timetable under which it operates. Without going into all the technical details, we may note that after October 15 (when 359 days remain in the fiscal year) nothing done by the President or Congress can provoke sequestration, regardless of the amount it adds to the deficit.

**IS THE UNITED STATES AN ANOMALY?**

The Gramm-Rudman-Hollings law is a peculiarly American invention. It serves as a treaty between two politically independent and warring branches of government. This type of arrangement would be unthinkable in countries governed by parliamentary arrangements. Yet, some important lessons can be learned from U.S. experience, with application to some advanced democracies.

The first lesson is that budgetary norms are not self-implementing. It is one thing to announce a fiscal norm, quite another to achieve it. The gap between promise and results is wide in many countries, as evidenced by the persistence of high deficits and the continuing rise in public spending.

A second lesson is that the political capacity of government affects budgetary outcomes. A recent paper published in the United States by the National Bureau of Economic Research correlated the debt/GNP ratio of democratic countries with various measures of political strength. The not-so-surprising conclusion was that strong governments have lower ratios than weak ones. While political weakness in the United States derives from the separation of power between the legislative and executive branches, in other countries it may be due to unstable coalitions, minority government, or frequent elections.

Finally, budget control cannot be effective if it fails to deal with the growth in transfer payments. Almost all such payments were ex-
emptied from the Gramm-Rudman-Hollings process. In fact, during the current (1990) fiscal year, approximately $650 billion in nondefense expenditures were excluded from the sequester and another $125 billion were subjected to only a limited sequester. Less than one fifth of total nondefense spending was fully subjected to the GRH process.

For the United States and other developed democracies, the test of whether they have purged the deficit problem lies ahead. In my view, they have not.
Role of Public Expenditure Management in Structural Adjustment Programs

RIFAAT K. BASANTI

Since 1986 the Fund has embarked on a number of structural adjustment programs with eligible member countries. During the past few years there has been considerable discussion on how structural programs supported by resources from the IMF and the World Bank could more specifically integrate growth-oriented policies to achieve growth objectives in a medium-term context. In 1987 the Group of Twenty-Four proposed, for example, that “growth exercises” be performed prior to the “financial exercises.” From these exercises the amount of external finance necessary to support a growth-oriented adjustment program could be determined. The objective of this paper is to discuss some of the public expenditure management (PEM) measures that were included in Fund-supported structural adjustment programs. The first section briefly outlines the central role of fiscal programs and their interaction with structural policies; the second section outlines the key areas where measures were taken to strengthen public expenditure management in SAF programs; and the remainder of the paper addresses the question of the degree of effectiveness of such systemic and process reforms in an attempt to highlight problem areas that may need to be taken into account in the design and implementation of PEM measures, particularly those relating to motivation issues.

1Reference is to the International Monetary Fund’s structural adjustment facility (SAF) and the enhanced structural adjustment facility.

CENTRAL ROLE OF FISCAL PROGRAMS IN STRUCTURAL ADJUSTMENT

A country that adopts a SAF-supported program prepares a policy framework paper (PFP) in collaboration with the staff of the Fund and the World Bank. Since the establishment of the SAF in March 1986 over 25 countries have received SAF assistance, of which several have embarked on a second annual arrangement. While the focus of the PFP has been on "structural measures," the programs have simultaneously concentrated on stabilization measures. These programs differed significantly to reflect the different structural problems of different countries. Underlying the focus on growth-oriented programs is the recognition that the extent to which inflows of foreign saving may be relied upon to finance domestic investment and growth is likely to be limited, particularly in the current circumstances of excessive external debt of many developing countries. Since the counterpart to an excessive level of foreign borrowing is an unsustainable external or balance of payments current account deficit, the common objective of programs (both stabilization and structural adjustment) has been to improve the current account; this will necessarily involve a reduction in the net inflow of foreign savings.3

With limited foreign borrowing, achieving a higher growth in potential GNP will require focus on three goals: increasing domestic savings, raising productivity of domestic factors of production, and lowering the cost of capital. The attainment of these goals involves, in turn, two policies: structural policy and fiscal policy.

Structural policy is often loosely used to encompass a wide variety of measures that can raise the level of potential output in two ways: by increasing total factor productivity or promoting capital formation through strengthening incentives to save and invest; and by removing rigidities such as institutional and regulatory barriers and price distortions to improve resource allocation and thus productive capacity. These measures include a host of reforms in sector-specific areas, financial liberalization, tariff reforms, pricing and marketing systems, and incentives for savings and investment that go beyond the scope of this paper. It should be noted, however, that the design of those incentives and institutional policies poses serious challenges with respect to information requirements for quantification of growth measurement. They may often require some degree of faith in regard to design and impact, under conditions of uncertainty.

Fiscal policy measures to increase government savings by reducing government spending or by raising revenue are relatively more easily

3For more detail on the theoretical foundations of Fund-supported adjustment programs, see International Monetary Fund (1987).
quantified and frequently involve steps that are under the direct control of the authorities. Inasmuch as a reduction in dissavings by government would release financial and real resources that could be used for capital formation and growth over the medium term while diminishing reliance on foreign savings, fiscal policy remains a key ingredient of Fund-supported programs to achieve stabilization and growth. The design of fiscal policy measures, however, has become increasingly complex owing to the extensive interaction in the effects of fiscal and structural measures. As can be seen from the simplified diagram (Chart 1), achieving the key goals of growth (including poverty and income distribution), inflation reduction, and debt management can be seriously influenced by actions on public sector incomes or expenditures. Fiscal measures have important macroeconomic effects, and simultaneously have strong microeconomic consequences with respect to the economic performance of key sectors—directly through budget operations (such as investment in infrastructure) and indirectly through the effects on private sector incentives (for example, through taxation).

Fiscal targets can be defined in a variety of ways, including targets on public sector borrowing requirements or a deficit target defined to be the operational deficit (inflation adjusted), or primary deficit (non-interest), or structural deficit (corrected for cyclical factors). However defined, the fiscal deficit should not be destabilizing with respect to inflation or onerous with respect to foreign or domestic debt. While reduction of the deficit is necessary, it is however not a sufficient condition for ensuring compatibility with growth targets. Tanzi (1987) suggested that the design of measures should take into account the structural impact with respect to durability and efficiency. Measures of a temporary nature such as civil service salary cuts and wage freezes or collection of taxes in advance are bound to be of short durability and could self destruct. Measures that impair economic efficiency (such as export taxes) are also counterproductive. A good deal of emphasis is therefore currently put on design of fiscal measures that are “structural” in nature—that influence the key variables for boosting growth potential. As mentioned above, these reform measures should enhance the medium-term prospects for private and government savings, more efficient management and utilization of external borrowing relative to the cost of capital, improving investment incentives, and accelerating growth of factors of production.4

As fiscal programs improved in “quality” with respect to growth-

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4For a more detailed discussion, see Hernández-Catá (1989), in which the point is made that embarking on a growth-oriented program would in itself potentially reduce the cost of capital or interest rates on foreign borrowing thought of as increasing with the level of indebtedness relative to the country's GNP (that is, its creditworthiness).
Chart 1. Policy Reforms Under Adjustment

TARGETS
- DEBT

MACRO
- GROWTH
- EMPLOYMENT
- POVERTY
- EXTERNAL
- FISCAL
- FINANCIAL
- EXOGENOUS SHOCKS

BUDGET DEFICIT
- EXPENDITURE
  - Interest Payment
  - Other Current Public Investment
- REVENUE
  - Tax Policy
  - Public Enterprise Pricing

INFLATION
- MONEY GROWTH
  - Interest Rate
  - Credit Allocation

SECTOR
- AGRICULTURE
  - Farm Price
  - Input Subsidy
  - Private Investment
  - Export
- INDUSTRY
  - Pricing
  - Technology
  - Regulation
  - Private Investment
  - Export
- OTHER SECTORS
  - Human Resources
  - Urban
  - Energy
  - Infrastructure

oriented goals, they also became more complex to analyze and implement. The impact of fiscal/structural measures on growth of productive capacity involves delays of two kinds: first, many measures that address incentive systems (such as supply-side taxation) may involve short-term deterioration in revenues and may have a lag before their macroeconomic effects are realized; second, many policies take time to put in place, especially when institutional changes and political support are required. These factors contribute a great deal of uncertainty to the results of growth exercises in general and of fiscal programs in particular. To address such uncertainty, programs have tended to be very comprehensive with respect to the number of measures included. However, this raises questions of timing and the institutional capacity of the public sector to coordinate and implement such programs. In this regard, many programs have advocated technical assistance in a wide variety of areas to deal with the requirements for institution building and reorientation that are needed to support these structural reforms. Fiscal advice provided by the Fund within programs supported by the use of Fund resources, or in the context of surveillance and regular consultations is structured through a well-established formal financial accounting framework.

During program implementation, managing scarce resources in the public sector has often been the critical test to make or break a program. Public expenditure management issues have usually been most pressing either because domestic resources have been slow to improve or because growth has not yet materialized, in which case accommodating political pressures for expenditure may be financially destabilizing and constitute a serious setback to the adjustment effort.

**REFORMS IN EXPENDITURE MANAGEMENT PROGRAMS**

It is difficult to generalize among country experiences, but in most countries with a SAF program the system of public expenditure management exhibited serious weaknesses in a variety of areas. Years of neglect have taken their toll as systemic or process reforms were only addressed during periods of crises and the psychology of control resulted in excessive rigidity that was introduced to resolve temporary stresses but tended to remain well after the crises had passed. Fragmentation of decision making and neglect of information systems put PEM systems at a serious level of disrepair. While the capacity for

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5 Timing and pace of adjustment to achieve a certain goal will depend critically on the institutional ability and political commitment.


7 The causes and effects of such weaknesses are adequately covered in other papers in this volume (see, for instance, Premchand, Chap. 2).
comprehensive system reforms has been limited in the short term, the following have been some of the priority areas for reforms under SAF-supported programs. Features of these programs in the budget and expenditure control area are shown in Table 1.

**Public Expenditure Planning and Budgeting**

Two main problems weakened the process and functioning of expenditure planning and budgeting. First, there has often been a lack of systemic planning within a macroeconomic framework, which has tended to reduce the ability of the fiscal authorities to adapt to changes in economic conditions, leading to piecemeal and ad hoc responses that contribute to additional distortions and hinder the optimal use of scarce resources. Across-the-board cuts were often made to the detriment of priority activities. Second, institutional weaknesses have led to poor coordination between planning and finance agencies. This resulted in rigidity with respect to monitoring and adopting program changes that might be needed to meet the long-term targets of public expenditure.

To remedy these problems, three fourths of the SAF adjustment programs incorporated expenditure planning reforms, particularly the introduction of program and performance budgeting to promote cost measurement and containment and to improve productivity of expenditures. Most programs provided for a review of expenditure priorities to restructure expenditure patterns for more efficient use of resources such as on operations and maintenance. About half of the programs plan to strengthen multiyear expenditure planning to allow for analysis of resource implications over the medium term. Improvements in budget structure allow rolling expenditure plans and budgets to be adaptable to resource realities and unanticipated changes. Several countries plan to unify their budgets to include both current and capital items. Many reform programs aim to strengthen the process of public investment selection, emphasizing the financial links with the balance of payments profile, the foreign exchange utilization budgets, the debt profile, and the recurrent cost implications. Several countries also have initiated the preparation of a list of priority projects to submit for donor support. Efforts have been made to improve the capacity for public investment reviews and monitoring mechanisms.

To improve institutional coordination at the technical level of budgets and plans, some countries established working groups or committees of staff from finance, planning, and other agencies to undertake projections of key economic trends underlying the macroeconomic framework of the program.
Implementation, Monitoring, and Control

The budget implementation phase is crucial to ensure timely and effective delivery of services, consistent with approved policy goals. Expenditure management needs to ensure economy in using resources relative to planned levels, efficiency in achieving the desired output, and effectiveness in fulfilling program objectives. These aims can be achieved only if budget managers are able to take account of new developments that may require a reallocation of resources. In several countries, common problems in budget implementation (which were usually manifestations of poor budget structure and process) were related to rigidity in procedures for the release of funds, delays in releasing funds for capital budgets, absence of systematic commitment controls in finance ministries and spending agencies, and lack of congruence between physical and financial results, or between inputs and outputs (which often contributed to an implementation illusion); excessively centralized payments systems gave the illusion of cash management—often compromised by incurrence of arrears through failure of proper commitment controls for contracts and procurements and the rush of expenditure before year-end; and poor information on inter- and intra-government arrears with autonomous agencies and special funds were sources of extrabudgetary expenditures that often resulted in a failure to achieve targets.

Most countries with SAF-supported programs have had to reassess the effectiveness of their implementation, reporting, and control systems and have identified specific areas for quick reforms. In 17 countries, procedures for the release of funds were revised to control unauthorized expenditures, fund allocation, and to monitor more closely the release of investment funds through a better reporting and monitoring arrangement that involves closer coordination with donors, planning agencies, and line ministries. In 21 countries, procedures to strengthen commitment control were put in place, including assignment of ministry of finance accountants to spending agencies, and a requirement for authorization of expenditure vouchers by the accountant general’s office. In over half of the SAF-supported programs, measures were taken to strengthen the government accounting and financial reporting systems. They aim at improving monitoring of treasury operations by modernizing the reporting and accounting systems through computerization and training of accountants, and expanding coverage of the information system by improvements that include reconciliation with central bank accounts, coordination of foreign aid disbursements, and consolidation of special accounts, revolving funds, extrabudgetary operations, and transfers and arrears with public enterprises. A few reform programs estab-
<table>
<thead>
<tr>
<th>Fiscal Measures</th>
<th>Number of Countries</th>
<th>Reforms Targeted at Influencing the System Component</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Decision making</td>
</tr>
<tr>
<td><strong>Public Expenditure Planning</strong></td>
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<tr>
<td>Program and performance budgeting</td>
<td>16</td>
<td>x</td>
</tr>
<tr>
<td>Rolling expenditure planning</td>
<td>13</td>
<td>x</td>
</tr>
<tr>
<td>Development of public expenditure planning in</td>
<td>15</td>
<td>x</td>
</tr>
<tr>
<td>macroeconomic framework</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public investment review and project selection</td>
<td>23</td>
<td>x</td>
</tr>
<tr>
<td>Introduction of public investment budget</td>
<td>7</td>
<td>x</td>
</tr>
<tr>
<td><strong>Budget Structure and Process</strong></td>
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</tr>
<tr>
<td>Improvement of budget classification and nomenclature</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Link between development plan and annual budget</td>
<td>15</td>
<td>x</td>
</tr>
<tr>
<td>Foreign exchange budgets</td>
<td>2</td>
<td>x</td>
</tr>
<tr>
<td>Elimination of extrabudgetary accounts</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td><strong>Budget Implementation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improved procedures for release of funds (e.g., quarterly allocations)</td>
<td>17</td>
<td>x</td>
</tr>
<tr>
<td>Commitment control</td>
<td>21</td>
<td>x</td>
</tr>
<tr>
<td>Identification, measurement, and clearance of arrears</td>
<td>19</td>
<td>x</td>
</tr>
<tr>
<td>Improved financial management in spending agencies</td>
<td>10</td>
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<tr>
<td>Government Accounting and Financial Reporting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improvement in treasury operations</td>
<td>13</td>
<td>x</td>
</tr>
<tr>
<td>Improvement in monthly reporting</td>
<td>12</td>
<td>x</td>
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<td>Monitoring flows between government and enterprises</td>
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<td>Improved assessment of financial performance</td>
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<td>Improved government supervision and control</td>
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Sources: International Monetary Fund, Fiscal Affairs Department, and Huyser (1988).
lished formal quarterly reviews of fiscal developments to ensure coordination among key economic management agencies on a regular basis to respond to adverse developments as soon as they arise. Improvements in accounting and audit were started in a few programs to ensure accountability in government and in due course to encourage the accounting corps to play a more active role as financial advisers to budget resource managers, particularly with respect to assessment of costs and future contractual arrangements.

Most SAF-supported programs attempted to tackle the problem of controlling personnel expenditures. To varying degrees, over half of those also examined ways to introduce civil service reforms and administrative reorganization of ministries and agencies. Improvements in staffing of government—particularly to stop the erosion of skilled personnel to the private sector (the revolving door in the public service)—are difficult to resolve quickly, as they involve complicated reorganization exercises in civil service incomes and incentive systems.

Almost all SAF-supported programs have included structural measures to rationalize public enterprise finances and to control and monitor flows between government and public enterprise budgets. Improvements in the information system with respect to the performance of enterprises are critical for fiscal and macroeconomic management. Gathering accurate financial information on their performance is a prerequisite for initiating financial and economic restructuring strategies for the public enterprise sector. The strain of managing the reforms in this area on the limited institutional structures in the government should not be underestimated.

**PROBLEMS OF SUSTAINING PROGRESS IN STRUCTURAL REFORMS**

Most of the reforms concerning systems and process changes under SAF-supported programs were undertaken with urgency to tackle the immediate shortcomings in the PEM system as they were identified. They constitute a first phase of reforms to set the stage for more comprehensive changes in the future, because in most countries that embarked on comprehensive SAF-supported programs the institutional setup has been very weak. Recent work on the design of public expenditure management systems examined the reasons for the slow progress of reforms in SAF countries (see papers for the Seminar on Public Expenditure Management for SAF country officials held August 29—September 8, 1988). This section examines the reasons for

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8Premchand (1988); for a report on the proceedings, see Basanti (1988).
the slow progress in achieving results of structural reforms in general and of PEM reforms in particular.

Two principal areas of concern regarding expenditure management in developing countries can be highlighted: (a) structural measures are inherently slow to develop, particularly as they require extensive institution building and political consensus (referred to as the sociology of structural reform), and, in addition, they also take a long time to effect macroeconomic improvements (in GNP or the balance of payments); and (b) there are serious weaknesses in the decision-making system of government that are further exacerbated by the crisis management that stems from the immediate problems of inflation and external debt.

It is natural that as economic growth materializes and more resources become available, budgets face a less stressful environment. In the transitional period when growth has not yet been achieved, decision making should not be distracted by day-to-day, ad hoc responses to crisis, that is, a tactical approach. Instead, the principal challenge for structural reforms is to identify a setup or system that deals with the crisis and at the same time has a clear view of the medium- and long-term strategy. It is critically important to the question of sustaining progress. If budget systems permit a more explicit recognition of uncertainty and consideration of contingency mechanisms, temporary setbacks or slow results with respect to structural reforms should not lead to policy reversals.

In addressing the question of sustainability, two prerequisites should be noted: (a) realism in the design of reforms that would map policies over the long term and anticipate quick and measured responses to shocks (including shortfalls in financing); and (b) commitment by decision makers to the reforms, which would entail political and social consensus building and a clear view of the priorities that are essential to the structural reforms. Surprises in either of these two conditions without the ability to make quick corrective changes could make it difficult to achieve structural reform objectives.

The integrated system for decision making in PEM should be examined carefully with respect to its critical components:

- the decision-making structure (D);
- the information system (I); and
- the motivation process (M).

The PEM reforms under SAF-supported programs were examined to discover how they relate to the components of this DIM approach. As shown in Table 1, most of the reforms were designed to help decision

§See Basanti (1988).
making and to improve the information system. Very few were undertaken to influence motivation for implementing reform programs, which is not surprising because "motivation" questions have a lot to do with the authorities' commitment. Commitment cannot be easily helped by system improvements; it either exists or it does not. But without it, the capacity to sustain structural reforms is weakened. Often, it is a question of leadership in the economy. As problems become more difficult (stabilization, poverty, and even political-social problems), it becomes even more elusive just when more firm leadership is needed.

It is important to examine the three components of the DIM approach to analyze the performance of structural reforms.

The decision-making structure reveals the identity of the decision-making authority, the decisions it can make, and the basis of that authority. In its most fundamental sense, a decision-making authority implies the probability that policymakers can effect the resolution of a decision to serve the chosen objectives. The information structure in essence provides managers and implementing agencies with information that reduces the inevitable uncertainty associated with an environment in which both the set of feasible actions and the state of relevant events are constantly changing. The motivation system characterizes the way control is exercised to secure compliance with decisions. Failure or slippage in any of the three components could result in partial implementation of fiscal or structural reforms, and partial implementation may often accentuate, rather than reduce, the problems.

Chart 2 gives a simplified exposition of the systems analysis approach required to put the role of structural adjustment reforms into proper perspective.\textsuperscript{10} The outcomes of economic policies are measured by indicators of economic activity in the public and private sectors and reflect decisions taken in both sectors. These decisions are usually taken in response to the specific socioeconomic environment of the economy and are revised according to assessments by the economic agents in both sectors of the possible impact of changes in policies, in the institutional structure of the economic system itself, and the effects of exogenous shocks on the environment. The norms by which public and private decision makers evaluate economic performance also change in this dynamic setting and are over time re-

\textsuperscript{10}A more complete description of this framework (used here primarily for public expenditure management issues) can be found in the decision theoretic approach originally presented by Koopmans and Montias (1971) as it was more generally applied to the behavioral study of comparative economic systems and other forms of organizational structures.
defined through a learning process. Short-term policies could be taken to achieve goals of stabilization; however, to ensure more sustained and durable results to achieve economic growth and development...
goals, economic policies need to be consistent with more far-reaching or structural changes developed within a comprehensive strategy over the longer term. Such changes will require a re-evaluation of the decision-making structures in the public sector. For example, many activities that were exclusively the domain of government budgets may under such programs be provided by the private sector (health, education, public works, services, etc.). The institutions in the public sector in charge of supervising the progress and management of funds will differ in organizational setup and orientation from their predecessors, which were control oriented through rigid and outdated traditional public sector expenditure control procedures. Such a change in orientation of institutions in charge of making public expenditure decisions is not easy to design or to establish overnight. The information requirements of the institutional reforms will also change in that simple expenditure reporting will no longer suffice; instead, exchange of information on private sector vendors’ prices and quality of services is required. Control procedures to safeguard against kickbacks or influence peddling are also needed. Thus, public expenditure management procedures need to be adapted to the changing relationships between the public and private sectors. The need for such changes in the orientation of public sector institutions can be seen even more clearly under the structural reform measures in the parastatal sectors, where reforms take place in the decision-making structure of the sector through a managerial and financial restructuring mix; in the information system on financial performance vis-à-vis the market; and in the motivation strategy, particularly with regard to the wage and employment reorganization and financial incentives schemes that may now accord a higher weight to efficiency and profitability rather than to other noncommercial objectives. The cost of pursuing noncommercial objectives should no longer be hidden but should be made more transparent and should be reported for regular review by public sector decision makers.

It is important to recognize that paying lip service to fundamental structural reforms, or avoiding the vigorous implementation of key structural changes that influence the incentive system (or motivation system) in the economy would lead to unsustained efforts. Piecemeal changes through many small steps are a poor substitute for structural reforms, and inasmuch as they represent a resistance to undertake the critical structural reforms, they inevitably lead to unsustained results and to adjustment fatigue.

To influence sustained implementation, a certain stability in the decision-making process in the public sector is of paramount importance. A good and timely information system helps decisions to be taken at the right time but may not ensure implementation. Defining
the responsibility of central and executing agencies with regard to key issues of public expenditure is of central importance.11 Two elements in defining responsibility should be noted: (a) delegation (that is, management by exception), and (b) centralization versus decentralization. Agencies need greater flexibility in using financial, material, and human resources; at the same time they should be accountable for the cost effectiveness of their activities and should be given incentives to generate savings and retain control over a portion of the resources saved. Managerial skills should be identified in key areas and good performance should be rewarded. It is imperative that the channels of communications be open between politicians (top decision makers) and top civil servants. With respect to centralization, however, high-level committees could be formed (for example, as in Australia) that would map a course of long-term structural change and design budget priorities in a nonpartisan setting to help insulate top management from political influences that lead to its instability. A core of well-trained and properly remunerated middle and top managers needs to be maintained to reduce the uncertainty of the decision-making structure.

It has long been recognized that budgets implicitly serve three decision-making functions: planning, control, and motivation with strong feedbacks. Integrated strategies that map the feasible sequence of structural reforms in PEM systems should strive to achieve a better delineation of budgetary decision-making structures, and fiscal information systems should be modernized to allow for multiyear policy planning with provisions for contingencies, while control systems should be reviewed to reduce their rigidity and to make them more realistic in their objectives. Since these reforms will take time to design and implement, a sustained effort is needed. The fewer reversals and interruptions, the higher is the probability of success in achieving the results of structural reforms.

**MOTIVATION ISSUES**

Analyses of the motivation process in PEM are still at a nascent stage.12 Individuals or institutions (groups of individuals) in general

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11In the initial stages of structural adjustment, fiscal measures taken on the revenue side may involve significant lags in their revenue effects as they concentrate on improving the supply side. This places a greater urgency on the immediate changes on the expenditure side if the budget deficit is to be stabilized simultaneously. Thus, this section concentrates on public expenditure management issues.

12For a review of relevant literature on motivation theories, see Blakeney (1983) and Ronen and Livingstone (1983).
are motivated by pecuniary or nonpecuniary incentives (positive rewards) or disincentives (penalties). Pecuniary rewards or penalties in the form of material benefits and costs are powerful motivators. However, in different societies and cultures individuals or organizations may be less responsive to material incentives and more responsive to nonpecuniary motivations. These motivations may include considerations of stability, a sense of belonging, social recognition, and full achievement of potential. The above discussion of sustaining structural and institutional reforms can be viewed from this vantage point because of the strong links within the DIM approach. In the context of PEM systems, credible strategic decision making that is sustained over several years would usually be consistent with successful adjustment. This, in itself, may have a significant motivating force, as success breeds success enforced through the system’s perceived stability, which may give rise to organizational unity around successful leadership or management.13

The recent experience with structural changes (see Table 1) provides four examples of areas where the motivation process had the potential of being positively influenced by PEM reforms. First, among the clearest examples is that related to civil service reforms; it should come as no surprise that a poorly remunerated civil service would be unmotivated and inefficient. Many years of reduction in pay in real terms or of policies of gap narrowing in which top ranks receive lower salary increases than lower ranks erode the motivation of middle- and top-level managers, particularly at times of fiscal restraint when their managerial skills are most needed. Similarly, where rigid civil service pay scales and noneconomic (sometimes politically influenced) employment policies and practices are applied to nonfinancial public enterprises, poor motivation of management and alienation of workers would lead directly to serious losses in efficiency with major financial consequences. Civil service reforms with regard to management structures and differentiated pay scales within the public sector that are more directly linked to job grading and performance would have clear motivational advantages. In the transitional stages, human development programs (such as training) may be needed to help public sector workers adjust to their new roles under the institutional changes.

Second, among the main advantages of program and performance budgeting is the reorganization of decision making to the more man-

13In management science, motivation of individuals to maximize efforts in achieving the organizational goals without direct pecuniary rewards is referred to as X-efficiency (Leibenstein (1978)).
ageable level of the program. If successfully implemented, this would address a principal demotivating influence on middle-level managers: that of having a large uncoordinated bureaucracy that they cannot influence and that is rigid and irresponsible. Under program budgeting, participation by program managers in the decision-making process is highly motivating, as middle-level managers could more fully achieve their potential, and as they can be more effectively utilized as financial advisers to top decision makers.

Third, at the budget implementation stage, rigid, outmoded, and poorly designed traditional controls over spending agencies are a source of negative motivation. As better control systems evolve that are differentiated to allow some flexibility to implementing agencies in exercising financial judgments (for example, with regard to value-for-money evaluations), agencies may be more positively motivated.

Fourth, the recent experience of some countries has shown that to motivate top managers of nonfinancial public enterprises a contract could be drawn up between the government and the management of the enterprise. Such a contract would clearly define the achievable objectives and identify performance clauses (the rewards or penalties). Managers are positively motivated by the noninterference of regulatory agencies that is accorded in such contracts and that grants them the freedom to take the commercial decisions needed to achieve the contract objectives within a competitive market environment. Performance is usually measured only on the basis of those factors under the control of the managers; that is, the financial costs of losses owing to the pursuit of noncommercial objectives are not attributed to the inefficiency of enterprise management but are calculated separately and are reviewed by government to determine whether they represent justifiable deficits or costs.

In conclusion, motivation issues are critical to the successful implementation of PEM decisions. Any reforms in this system should be designed not only to improve decision-making structures and information systems but should also always be subject to review with regard to their motivational intent and effects.
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Rolling Expenditure Plans: Australian Experience and Prognosis

MICHAEL KEATING and DAVID ROSALKY

INTRODUCTION

As in other countries, Australian Governments in the 1970s and early 1980s found themselves presiding over apparently inexorable growth in the public sector. This growth was fueled by public expectations that had failed to adjust to slower economic growth, and that were arguably a cause of that slower economic growth. When a new government took office at the nadir of an economic recession in 1983, it was faced with a quite unacceptable prospective budget deficit. This largely reflected a blowout in outlays, and as there was deemed to be no possibility of increasing the burden of taxation, savings relative to prospective outlays were the first priority for fiscal policy.

This background is essential to the Australian Government’s reforms of public sector management and the budget. However, the reforms have not only been concerned to establish tighter expenditure control but also to establish a system of public administration that was both more responsive to government priorities and more effective in implementing those priorities. Indeed, in its first year in office, the Government released separate discussion papers on public sector reform and budget reform that were directed to these overlapping purposes. Thus, a principal aim of budget reform was “to develop a better means of identifying and setting budget priorities” (“Budget Reform” (April 1984), p. 1), which depended in significant measure on achieving the first objective of public sector reforms, namely, establishing “an administration that is more responsive to Ministers and Parliament” (“Reforming the Australian Public Service” (December 1983), p. 1). In addition, the budget reforms were intended to upgrade the financial management of programs, to focus
attention more closely on the goals and objectives of particular programs, to review regularly their cost effectiveness and efficiency, and to ensure that the results of such reviews are taken into account in the ongoing evaluation of budgetary priorities.

What is interesting about the Australian experience, therefore, is how the Government has sought to combine fiscal restraint with the devolution necessary to achieve a more responsive administration, better resource allocation, and improved public management. Normally those two objectives of restraint and devolution are hard to combine. As a general rule, the greater certainty and stability necessary to underpin devolution to one level of management implies less flexibility to reallocate resources at a higher level of management. How, for example, does one ensure that the advantages of greater stability for program managers are not thwarted by the need for budget flexibility at the political level, including the need to be able to shift priorities from one budget to the next? Similarly, how useful to managers is their devolved responsibility for results in an environment of centrally imposed expenditure restraint?

The establishment of reliable and centrally determined forward estimates for all government programs, in conjunction with a system of program management and budgeting, has been essential to the resolution of these tensions. In particular, the present stability in program funding has depended upon the improved quality of the forward estimates and the avoidance of unexpected blowouts. It is within the tight aggregate controls based on the forward estimates that a system of program management and budgeting has been established that aims to maximize managerial flexibility and incentives.

It is against this background that this paper describes the development of, and experience with, rolling expenditure plans based on forward estimates of expected budget outlays in Australia.

**EVOLUTION OF THE FORWARD ESTIMATES**

Ever since 1973, the Australian Government has taken the view that preparation of the annual expenditure budget requires a perspective beyond the year in question. Very few decisions taken by the Government have an impact that does not transcend the present year—indeed, most are open-ended in time and can be expected to affect estimates beyond the time horizon of politicians and bureaucrats.

In Australia, as in most countries, the “budget” is a single-year document, in that the Parliament can only appropriate funds for general government operations for one year at a time, and, by convention, the event of presenting the budget to the Parliament constitutes an annual statement of the state of the economy and an occasion to
promulgate the Government’s plan of action in all its areas of activity for the next year. This annual submission to Parliament is largely an illusion, however, as nearly three fourths of the outlays covered in the budget are authorized by standing legislation and are characterized more by their stubborn permanence than by their susceptibility to the changing priorities of governors and legislators. Furthermore, much of the remainder is also predetermined by implicit contracts of employment or expectations of future funding. The projections of expenditure over the coming years, therefore, are well determined in principle.

Prior to the incumbency of the present Australian Government, the projection of a spending “base” over the next three years formed the starting point for the budget. All budget-dependent agencies, which constitute departments of state and noncommercial statutory authorities, would be requested to submit estimates of the expenditure levels required over three years in order to maintain those programs and activities authorized by the Government in past budgets (or possibly since the last budget). By definition, these estimates were not to cover new programs or significant extensions of the scope or size of existing programs. These estimates were collected by the Department of Finance, which is the central agency with responsibility for public expenditure management and policy. The estimates were generated by individual agencies and expressed in then-prevailing prices, so that price adjustment was under central control. Any terminating program, for example, subject to sunset legislation or a capital program requiring ongoing authorization, was excised from the total estimates. Once submitted, the estimates were collated by the Department of Finance for government consideration under the cloak of secrecy that characterized budget preparation. Their purpose was to allow the Government to assess the scale of the budgetary task facing it and thus to settle on a broad strategy. These estimates were then promulgated to agencies as guidance in preparing their bids for budget funding.

The product of this process suffered serious deficiencies. First, the budget process encouraged agencies to raise their bid to create some padding for the inevitable cuts and to minimize real pain. The forward estimates constituted “wish-lists” and not the base estimates that were intended. That this was possible reflects the breadth of interpretation that can be attributed to government decisions that

In 1974 and 1975, the forward estimates spanned only two years and, in the subsequent two years, reverted to single-year estimates. Three-year estimates have been the norm since 1978. A tabular history of the collection of forward estimates of outlays by the Australian Government is presented in the appendix.
define existing policy, and consequently program costs, especially over the mists of time. Indeed, it is part of the political armory to leave open the prospect of better circumstances ahead, and agencies, as well as clients, do not need to be invited to take advantage of any uncertainty.

Disagreements between the central and operating departments about what were properly authorized expenditure levels were expected to be resolved by officials, but many disputes had to be brought to the Cabinet to resolve. This process of negotiations and "disagreed bids" was time-consuming and inefficient, and it had developed an exaggerated role in settling the budget estimates.

A second deficiency was the conservative bias built into the estimates by the strict interpretation of continuing authority. Understandably, perhaps, there was an attitude within central agencies that inclusion of an item in the forward estimates constituted de facto approval. But, with the exclusion of major items, such as revenue-sharing agreements with other levels of government, because the term of the agreement expired during the forward period, the estimates became poor forecasts of pressures for expenditure.

As a result of these deficiencies, but also because the prevailing administrative procedures made forward estimates of little relevance to managing the present year's finances, scant attention tended to be given to the second and third years' estimates. In their old guise, therefore, the forward estimates represented little more than inflated bids for the budget year. There was no attempt to use them for medium-term expenditure planning, or even to take account of the medium-term implications of individual expenditure decisions.

**PUBLICATION AND IMPROVED FORWARD PLANNING**

When the present Australian Government assumed office in 1983, it was faced with estimates of outlays at their cyclical peak and heavily locked in, a fiscal situation that placed severe constraints on its ability to carry out its mandate. The Government therefore embarked on a program of public awareness of the need for restraint and better targeting of public expenditure. Indeed, its first day in office was dramatized by an announcement of the prospective budget deficit implied by the forward estimates. The publicity campaign was developed at a National Economic Summit conference held one month into its term of office, at which leaders of industry, trade unions, and community groups debated the economic agenda publicly with the Government. One of the information documents released to participants by the Government to enhance discussion was the (previously secret) "Report of the Forward Estimates of Budget Outlays" for the
ensuing three years. Publication has since been a continuing feature and in the recently released budget (August 1989), the forward estimates were fully integrated into the budget presentation, setting the outlays estimates and their analysis into a proper medium-term perspective.

Two important disciplines accompanied this more open approach to economic policymaking. First, the economic parameters underlying the projections were revealed and the uncertainty surrounding them made clear. A sensitivity analysis of the outlays estimates to the key economic parameters was also included so that the effect of the uncertainty in the economic forecasts could be assessed by readers.

The second discipline was the publication in the budget documents of a reconciliation of the budget and forward estimates showing the influence of policy decisions, both positive and negative, and parameter and other nonpolicy changes by functional classifications. This reconciliation analysis has been refined over the years to take its place now as a centerpiece of the presentation of outlays information (an example from the 1989 budget is presented in Table 1). In an environment in which a virtue has been made out of budgetary savings, this table clearly exposes the degree of fiscal discipline to which the Government has subjected itself, and consequently greatly encourages that discipline. More generally, heightened public awareness accompanying better disclosure has been a crucial factor in providing acceptance of the extended period of restraint experienced in Australia in recent years. Moreover, the information now available on the factors underpinning changes in program outlays has enabled such nongovernmental bodies as the Business Council of Australia to produce well thought out and influential proposals for expenditure restraint. To cite just one recent example, the information published in association with the forward estimates has played an important role in underlining the need for government action to control the burgeoning costs of pharmaceutical benefits, including such controversial initiatives as reducing the rate of remuneration of pharmacists.

The decision to publish the forward estimates and the increasing reliance upon them has greatly encouraged the improvement in their quality. Indeed, with the Government called upon to account for the extent of fiscal restraint against its previous projections of forward budget outlays, any blowout in those outlays would itself be very embarrassing. Nevertheless, the experience was that public exposure by itself did not lead to sufficient improvement in the quality of the estimates. While they remained departmental estimates, the dynamics of the budget process meant that they continued to reflect "bids" or even "wish lists." In particular, the first year of each new set of estimates tended to display strong real growth and bore little
relation to the previous forward estimates for that year even though all estimates were meant to represent a minimum cost of existing policies.

This led the Government to decide in 1986 that in future the Department of Finance would have responsibility for setting the estimates. This key change has resulted in a fundamental improvement in the quality of the forward estimates and their present status as a realistic and consistent statement of the baseline for the preparation of the budget. By no longer asking agencies for their own generous assessment of what they "need" to implement government policy, most of the creeping incrementalism that used to characterize successive budgets has disappeared. Indeed, as the New Zealand Treasury recently recognized, "The effect of (the bidding) system ... was to create incentives for managers to demonstrate a need for more resources, rather than to manage those they have more effectively. This has contributed to the great increase, in the size of the public sector, simply by accretion."²

MAJOR FEATURES OF THE AUSTRALIAN FORWARD ESTIMATES SYSTEM

Incorporation of the forward estimates as an integral component of the Australian budget has meant that they now do reflect the essential attributes of a rolling expenditure plan. The initial strategic planning, collation of spending plans and savings options from departments, and preparation of the now entrenched autumn (April or May) budget statement take place on the basis of three years of estimates. In May, when the most up-to-date and accurate figures are presented for the major budget deliberations by the Expenditure Review Committee of Cabinet, the cycle is advanced and a new third year is added. (During this phase, four years of estimates exist: the base estimates for the emerging budget and three forward years.) As the budget is produced in August of each year, the baseline for the next year is already established, publicized, and debated as part of the Government’s fiscal stance.

Estimates for all years undergo major reviews in January, when the midyear review of the current budget is carried out, and in May when the cycle is updated. Between these formal reviews, the estimates are kept up to date with amendments as necessary to take account of government decisions or major external shocks such as payouts for natural disasters or revaluations of capital works. The updating be-

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<td>606</td>
<td>830</td>
<td>223</td>
<td>163</td>
<td>60</td>
</tr>
<tr>
<td>Foreign affairs and overseas aid</td>
<td>1,551</td>
<td>1,493</td>
<td>1,564</td>
<td>71</td>
<td>65</td>
<td>13</td>
</tr>
<tr>
<td>General and scientific research</td>
<td>523</td>
<td>530</td>
<td>582</td>
<td>51</td>
<td>15</td>
<td>37</td>
</tr>
<tr>
<td>Administrative services</td>
<td>2,574</td>
<td>2,938</td>
<td>2,485</td>
<td>-454</td>
<td>-511</td>
<td>105</td>
</tr>
<tr>
<td>Total General Public Services</td>
<td>5,785</td>
<td>5,872</td>
<td>5,846</td>
<td>-26</td>
<td>-190</td>
<td>220</td>
</tr>
<tr>
<td>Not allocated to function</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assistance to other governments</td>
<td>13,606</td>
<td>14,288</td>
<td>13,978</td>
<td>-311</td>
<td>282</td>
<td>25</td>
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<tr>
<td>Public debt interest</td>
<td>7,403</td>
<td>7,345</td>
<td>7,280</td>
<td>35</td>
<td>127</td>
<td>—</td>
</tr>
<tr>
<td>Contingency reserve</td>
<td>-700</td>
<td>110</td>
<td>-590</td>
<td>-590</td>
<td>-590</td>
<td>—</td>
</tr>
<tr>
<td>Total Not Allocated to Function</td>
<td>21,009</td>
<td>22,233</td>
<td>21,368</td>
<td>-865</td>
<td>-181</td>
<td>25</td>
</tr>
<tr>
<td>Outlays Excluding Asset Sales</td>
<td>82,666</td>
<td>85,995</td>
<td>87,953</td>
<td>1,958</td>
<td>1,638</td>
<td>1,621</td>
</tr>
<tr>
<td>Asset sales</td>
<td>-538</td>
<td>-1,100</td>
<td>-1,200</td>
<td>-100</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>82,128</td>
<td>84,895</td>
<td>86,753</td>
<td>1,858</td>
<td>1,636</td>
<td>1,621</td>
</tr>
</tbody>
</table>
comes intense as budget time approaches. Each forward estimate is therefore reviewed formally six times (there being no review prior to the first publication) and published four times up to and including its release as the budget estimate. After that again, the estimates are reviewed twice more during the budget year and finally, more than four years after their initial collection, they are reported and archived as the budget outcome, in which form they are reconciled to the budget estimates. A depiction of the estimates cycle is presented in Chart 1.

Initial generation of the estimates and their progressive updates are carried out by the Department of Finance in consultation with operational agencies. Estimates are generated on the basis of a standard set of economy-wide parameters, in the form of quarterly projections of such variables as activity and employment levels, wage and price movements, and exchange and interest rates. The economic parameters are estimated using an official short-term forecasting model operated by the Treasury Department working within the constraints of policy targets. The considerable judgmental input contained in the forecasts is subject to the consensus of a committee of central agencies.

Economic parameters for the forward years are simple projections grafted onto the forecast period. Because of that and the uncertainties attached to noneconomic program variables, the third-year outlay estimates can be quite uncertain and more in the nature of a consistent projection than a forecast.

With economic parameters stipulated and any program-specific parameters generally mutually agreed with the operating department that is likely to have relevant expert knowledge, the influence exercised by the Department of Finance is in the sphere of interpreting the intent of Cabinet decisions and settling the estimates for administrative and other discretionary components of resource requirements. Dispute rarely arises at the point of inclusion of the new out-year estimate. This is partly because of the historical unimportance of the forward estimates in influencing government decisions, but increasingly it is because the rules for updating the estimates are clear (even if not always appreciated), and where there might be some room for discretion, ministers are now pressed to determine future funding for the out-years when they establish or significantly change a program.

The significance of central control of the forward estimates is apparent from Chart 2, which shows the strong growth built into the first forward year in the 1983 and 1984 reports, with lower, but significant, positive growth recorded in the subsequent three reports. It is also apparent that the second and third forward years generally contained only moderate growth. The first-year figure was seen by departments
Chart 1. The Estimates Cycle

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward Estimate 1</td>
<td>Forward Estimate 2</td>
<td>Forward Estimate 3</td>
<td>Forward Estimate 4</td>
</tr>
<tr>
<td>Publication of Budget and Forward Estimates</td>
<td>January Update of Forward Estimates</td>
<td>May Update of Forward Estimates</td>
<td>Add Forward Estimate 4</td>
</tr>
<tr>
<td>Budget Update</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publication of Budget and Forward Estimates</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
as staking an ambitious claim at the beginning of the budget negotiations. As such, the usefulness of the forward estimate as a baseline for ministerial deliberations, or as a publishable medium-term view of the Government’s spending intentions, was greatly diminished. Since the change in responsibility for establishing the estimates, however, the trend in the estimates has become a faithful reflection of the fruits of expenditure restraint. Not only has this had desirable publicity effects for the Government, but it has also stretched the outlook of ministers beyond the budget year as the effects of savings that are really only deferrals, or of back-end loaded new policies, become only too apparent.

The higher profile of the forward estimates has required a greater discipline on the Department of Finance also. Being a key player in the budgetary debate, it must be conceded that the department used also to take a strict minimal position in respect of departmental claims for resources and preferred to let ministers—hard-pressed to find savings—decide on so-called disagreed bids. The success of the present system depends to some extent on departments’ perceiving
that the baseline estimates are fair, if firm. This involves such inclusions as technical new policy additions for minor public works, funds for reasonable replacement of minor capital equipment or renewal of leases, increases in rent, etc. It has also required the Department of Finance to establish clear rules and better records of past agreements and decisions to support the estimation of general operational costs, an area where dispute can take place out of proportion to the funding involved.

**RUNNING COSTS SYSTEM**

The level of staff that can be employed and the associated salaries and other administrative costs will always be close to the hearts of decision makers, both ministerial and bureaucratic. In conjunction with the absence of bottom-line pressures or other equally effective accountability mechanisms, this has led successive governments in Australia, as elsewhere, to embark on a variety of methods to contain, or to reduce, staff numbers and operational expenditures. Consequently, the end piece of hard-fought budget rounds has sometimes been arbitrary cuts, selective or across the board, in staff numbers and administrative costs.

The Australian Government in recent years has tackled this problem progressively, moving in 1987 to a comprehensive running costs system. This system is characterized by a number of radical concepts:

- amalgamation of all running costs, salaries, and nonsalaries, into a single controlled amount with a single appropriation item for each agency;
- virtual elimination of controls on staff numbers, except at the senior executive level where departmental structures are determined;
- considerable flexibility for managers to allocate aggregate running costs, without reference to the Department of Finance, across programs, between salaries and other costs, and (within limits) between adjacent years;
- strict cash limiting within the budget year;
- determination of the forward estimates of running costs by a formula that essentially assumes their maintenance in real terms less an efficiency dividend to the budget of 11.25 percent per annum (in recognition of the scope for productivity gains), and adjustments are also usually allowed for changes in workload or new policies (above a predetermined threshold level);
- allowance within net appropriations for retention of some or all revenues through charging for services or disposing of underutilized minor assets;
a system of loans from the budget to finance worthwhile new investments and other initiatives, with the loans plus a real return to be repaid by reducing the forward estimates of running costs for later years.

This running costs system represents a major reform in favor of devolved responsibility and managing for results. It has greatly diminished the need for detailed examination of the estimates, intrusion by the Department of Finance, and the scope for contention with departments in setting forward estimates of their running costs. Although on occasions challenges to the application of the operating rules of the system still occur, they rarely proceed to ministerial level or require Cabinet to adjudicate.

The system, however, no longer encourages managers to waste their time pursuing unwarranted increases in their estimates. Instead the Australian running costs system now provides managers with clear incentives to pursue improved efficiency and better management. First, all savings from better efficiency over and above the efficiency dividend are retained by departments' management. Second, the introduction of user charging and the system of loans means that services to agencies and new investments are not rationed but are decided on their merits in terms of their ability to pay for themselves. Moreover, when a service is no longer provided free or a loan with interest has to be repaid, then there are clear pressures on agencies to reconsider how much they really want those services.

In addition to these incentives for better management, the flexibilities in the system also allow managers to manage better. The carry-over facility means that there is no longer the same pressure for an end-of-the-year spending spree to avoid being left with unused funds, and that could then result in a lower base for next year's appropriation. Similarly, the former system of expenditure control based on adherence to detailed appropriations for individual inputs (such as travel, postage, telephones, etc.) provided no flexibility to switch resources in response to changing priorities and circumstances. Without that flexibility, cash limiting was impossible. Instead there was frequent resort to additional estimates to provide the necessary flexibility, but this practice made Department of Finance officers, rather than line managers, responsible for financial management and further reduced the scope for forward expenditure planning as well as good management.

The significance of the running costs system to the topic at hand is that none of these improvements would be available without the forward estimates. For example, the return of savings from efficiency gains to agencies' managers is meaningless unless their base estimates have been decided in advance and are reasonably firm. Simi-
larly, the repayment of loans can only be effected by adjusting the forward estimates and that also provides a clear signal to the agencies' managers of what is expected from them.

For the system to work as intended, however, the forward estimates must be stable and consequently of high quality. The necessary improvements in their integrity have been achieved by setting the forward estimates for running costs essentially by formula. Moreover, this improved quality and stability has greatly reduced the risk of ad hoc budget cuts to running costs and staff numbers, which has encouraged greater managerial responsibility and thus, in turn, further enhanced the integrity of the estimates.

**PROVISION FOR CONTINGENCIES**

Unlike some other budgeting systems, such as Canada's Policy and Expenditure Management System (PEMS), the Australian budget estimates do not make allowance for prospective variations to budget figuring for decisions or other external influences. This apparent omission is part of the philosophy of budgeting adopted for many years: namely, that reviews of priorities, and spending and taxation decisions, are taken at one intensive annual review session and, barring unforeseen and unavoidable circumstances, the budget is set for the year. There is a process of additional, or supplementary, estimates late in the financial year to provide necessary additional appropriations generally for unavoidable "blowout" in the estimates, balanced to an extent by withdrawal of authority for known underspent appropriations. But this time is not meant for changing budget strategy. Of course, there is always leakage from this discipline, but the tight adherence to estimates in recent years (see Table 2) is testimony to the broad success of the approach. (In practice, the extra spending that does arise from intra-budget decisions is largely offset by the inevitable underspending from annual appropriations brought about by prudential management. In other words, the lack of a contingency reserve for new spending decisions during the course of the budget year counters the lack of an allowance for underspending utilized in some other countries.)

The forward estimates similarly do not contain the reserves that characterize the public expenditure management system. As such, the estimates are not forecasts of expected levels of expenditure, but rather baseline estimates to or from which all future decisions will be added or subtracted.

But the forward estimates are also intended to provide a direct measure of the scale of the budgetary task and a baseline against which the public can assess the Government's fiscal performance. It
Table 2. Budget Estimates and Outcomes for Outlays, 1979/80–1988/89

<table>
<thead>
<tr>
<th>Budget Year</th>
<th>Outlays Estimate (in millions of Australian dollars)</th>
<th>Outcome</th>
<th>Change (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979/80</td>
<td>31,692</td>
<td>31,694</td>
<td>2</td>
</tr>
<tr>
<td>1980/81</td>
<td>36,029</td>
<td>36,274</td>
<td>244</td>
</tr>
<tr>
<td>1981/82</td>
<td>40,877</td>
<td>41,339</td>
<td>463</td>
</tr>
<tr>
<td>1982/83</td>
<td>47,067</td>
<td>48,982</td>
<td>1,915</td>
</tr>
<tr>
<td>1983/84</td>
<td>56,590</td>
<td>56,570</td>
<td>-20</td>
</tr>
<tr>
<td>1984/85</td>
<td>63,843</td>
<td>63,739</td>
<td>-104</td>
</tr>
<tr>
<td>1985/86</td>
<td>69,048</td>
<td>69,917</td>
<td>869</td>
</tr>
<tr>
<td>1986/87</td>
<td>78,944</td>
<td>78,764</td>
<td>-181</td>
</tr>
<tr>
<td>1988/89</td>
<td>82,043</td>
<td>82,128</td>
<td>85</td>
</tr>
</tbody>
</table>

Note: As the outcomes shown for each year reflect the classification treatment adopted for the following year’s budget, the outcome figures in this table should not be compared between years.

is therefore important that the growth in total outlays revealed by the estimates is not subject to any conservative bias. Understatement of that growth would not only mislead the Government in its future forward planning but its subsequent correction could also lead the community to conclude that the Government had exercised less fiscal restraint than had in fact happened. On the other hand, correction of the bias could encourage expectations of future expenditure that is not presently authorized. This is most likely when the estimates for individual programs are maintained beyond the period for which they are presently authorized. But even a nonattributed general contingency reserve can encourage bids by spending agencies in the expectation that the Government has made sufficient provision to finance those bids.

In seeking to balance these considerations the Australian forward estimates do contain a modest contingency reserve. This reserve includes provision for new technical policy additions referred to earlier, such as minor public works and the replacement of minor capital equipment. A notional allowance is also incorporated for the extension of some programs. However, these notional allowances are not attributed to individual programs, and the contingency reserve is tightly defined to exclude any allowances whereby the Government could be expected at least to consider terminating or reducing the program.

The contingency reserve therefore tends to increase progressively, being largest for the third out-year, and diminishes as the contingencies become actual and are incorporated into the appropriate estimates. In aggregate the present forward estimates show a contin-
ergency reserve of about 0.1 percent of total outlays in 1989/90 increasing to about 1.7 percent of total outlays in 1992/93.

The remaining influences on the forward estimates are changes in economic parameters (the impact of which can be broadly estimated using the published sensitivity factors), and government decisions to vary programs; no contingency reserve is provided for these.

ADVANTAGES TO MANAGERS AND PLANNERS

Developments in the forward estimates process in Australia have underpinned reforms in resource management and have proved as important to program managers and planners as to budgeters.

As recently as 1983, a survey of senior managers found that 94 percent considered good financial management consisted of spending no more and no less than their budget allocation. Only 5 percent of them recognized their responsibility to consider improved resource allocation and to pursue more cost-effective results. The program management and budgeting system that has been introduced in conjunction with forward expenditure planning has revolutionized managers' thinking about what constitutes good financial management.

Because the program and running costs estimates on which managers base their planning are established quite firmly in advance, there is a reasonable expectation that they will not be varied up or down unless the Government makes an explicit decision to change its policy. Managers now waste much less time haggling over the details of the estimates with the Department of Finance, but instead get on with their real job of improving performance. When the Government does decide to change policy—possibly in response to budgetary exigencies, but also to improve value for money—the program parameters will be specifically adjusted and there is no arbitrary squeezing of the resources available to achieve the expected objectives. Thus, the implementation of programs and the delivery of services is greatly improved, as managers are able to plan activities and to focus on achieving planned objectives—an essential requirement when managers are expected to manage for results. Moreover, the flexibilities that allow managers to manage by allocating resources across inputs and programs, within years and between years, depend on their knowing in advance, and with surety, to what base level of resources these flexibilities are being grafted. When program funds are cut, it is generally in response to an explicit change in the program's objectives, so that the performance of managers is not assessed against unrealistic targets.

Devolution of managerial responsibility to program managers puts an onus on agencies to replicate within their own structures the rela-
tive independence that the forward estimates system has given to agencies. But that devolution requires, in turn, granting reliable forward estimates to agencies. Such devolution, in practice, is limited by the size of the units involved, since splintering managerial autonomy can cause the loss of administrative efficiencies and reduce the scope for an agency to reallocate priorities at the margin.

Greater reliability and integration of forward estimates into the budget have led to more accurate and considered costing of effects of future years by the proponents of spending or saving options. Ministers have therefore been less inclined to resort to short-term expedients, such as arbitrary cuts in agencies' allocations or deferrals, to meet their savings requirements. Instead, the requirement to consider the next three years' estimates encourages them to achieve expenditure reductions through considered changes to policy.

FORWARD ESTIMATES AND BUDGETARY CONTROL

The present Australian Government has been greatly assisted in its pursuit of expenditure restraint by its readiness to submit itself to the discipline of an overall fiscal target or targets. But over the years the exact expression of these targets has varied. In its early years the Government committed itself to a so-called trilogy which set, as an upper limit, that outlays, revenues, and the budget deficit should not increase over a three-year horizon as a proportion of gross domestic product (GDP). More recently, this has been replaced by a much tighter target involving real reductions in outlays and target levels for total public sector debt repayment (a negative public sector borrowing requirement). The gap between the forward estimates and the target level provides a ready measure of the Government's task in its expenditure deliberations.

The Government's performance in closing this budgetary gap has been routinely revealed through the publication of the reconciliation table referred to earlier that compares the forward and budget estimates. That table (reproduced here as Table 1), by identifying the role of parameter movements and other external influences separately from the impact of government decisions, shows the extent to which the Government has held new spending in check, or alternatively, has aggravated the task for the present and future years by agreeing to new expenditures. Moreover, the impact of these decisions on each functional area is presented explicitly so that the winners and losers from budget decisions to reallocate resources can also be clearly identified.

The strategic or "top-down" approach to setting an overall fiscal target or targets has been complemented by a refinement of the more
traditional "bottom-up" consideration of individual claims. Targets for each portfolio are also set on the basis of some consideration of overall priorities, new policy bids, and the scope for savings, and these targets are constrained to be consistent with the overall fiscal target. Portfolios are then asked to prepare options to meet their specific targets. This might involve net reductions or net increases to their forward estimates, but in either case portfolio ministers are able to increase their scope for new initiatives by finding more offsetting savings. Ministers and their senior executives are thus constrained to consider priorities and opportunity costs closely, and overall resource allocation is improved.

Since running costs are restrained to their forward estimate in aggregate terms only, there is also incentive to find savings within a portfolio's running costs, through efficiency measures, charging users for services provided, or retaining the proceeds from disposal of (minor) underutilized assets. The running costs and portfolio targets are interdependent, and it has become commonplace in some administratively complex programs to assign increased running costs, as new policy spending, to achieve greater program savings. Fraud and overpayment control in welfare benefits, or the collection of defaulted child maintenance payments are cases in point. This thrust has supported the Government's objective of improving targeting of budgetary assistance to the genuinely needy. But it has also created a significant offsetting factor to the restraint imposed on running costs by the efficiency dividend and other efficiency initiatives.

As the forward estimates have become more soundly based, it has become possible to set portfolio targets over the forward period. This has been done by imposing explicit dollar limits on new policy or savings packages to apply to all years, or by placing qualitative or quantitative constraints on full-year effects of proposals. It would not have been possible under earlier arrangements, because portfolios could generate "false savings" and increase their access to new policy funds by trading off their inflated bids for increases in base estimates.

**PROBLEMS WITH THE FORWARD ESTIMATES**

The forward estimates, as operating in the Australian environment, attempt to serve two purposes: to establish a baseline for departments to prepare their budgetary proposals and to plan program implementation; and to present a realistic forecast of expenditure levels under existing policies. This dual purpose can lead to conflicting requirements.

A major difficulty in preparing budget estimates in the past has been the lack of precision in policy pronouncements. Governments
have been exhorted to specify the implications of their policy intentions for the forward years to facilitate planning, but that tends to increase the expectations of client groups and departments to a committed level of expenditure.

Similarly, the desirable control practice of "sunsetting" programs and making their continuation conditional on satisfactory evaluation, leaves a "hole" in the estimates beyond the terminating year, which is a major source of conservative bias. To the extent that "neutral" assumptions, such as continuation of the program at the same real or nominal level, are made to maintain integrity of the estimates, this will reduce fiscal flexibility at the macro level, and can even weaken fiscal discipline by raising the political cost of shifting priorities through any decision to terminate or to curtail the program. The same is true of other forms of new technical policy, such as funds to continue capital programs, or allowance for expected price and wage increases or currency devaluations. Certainty in funding conflicts with the pressure that constrained resources can impose to resist cost increases.

As noted earlier, however, in practice forward commitment of outlays was already extensive before comprehensive and controlled forward estimates were introduced. Some 70 percent of outlays is covered by standing legislation. Even for those programs that do not have continuing legislative authority, ministers tend to make political statements that commit the Government to maintain broad present levels of expenditure. Although the enhanced status of forward expenditure planning may have raised expectations about commitment to some programs, therefore, and thus resulted in some loss of fiscal flexibility, this has been more than balanced by the improved expenditure planning.

As long as the Government maintains tight control of its forward expenditure planning the experience has been that there is less blowout in the estimates from one year to the next, with less need for the major savings exercises that were a feature of past budgets, and the loss of fiscal flexibility is consequently less serious. Additionally, by encouraging ministers to consider the out-year consequences of each decision, the net reductions agreed for the budget estimates have been matched by net reductions in the forward estimates for subsequent years. As a result, recent experience has been that the forward estimates that have formed the starting point for a new budget have either been falling in real terms or held to almost no growth (see Chart 2), and that also has reduced the pressure to maintain fiscal flexibility to allow for further savings.

Clearly, the success of the Australian system of forward expenditure planning is sensitively dependent upon the quality of the esti-
mates. The trade-off between the sacrifice of fiscal flexibility for better expenditure planning will probably only remain acceptable while the integrity of the estimates is maintained. If, however, a major blowout occurred in those estimates, with consequential pressure for a major savings exercise to restore the estimates, the degree of “lock-in” implicit in the present system might well come into question.

Perhaps the major risk at present for the quality of the forward estimates is their dependence on forecasts and projections of economic parameters over a three-year horizon. Economic forecasting is always hazardous. In fact, official forecasts in Australia look only six quarters ahead, and the projections beyond that really only reflect a feasible and desirable economic scenario based on consistent assumptions.

Changes in the forecasts of economic parameters can however have perverse and offsetting effects on the forward estimates and it is these offsets that have probably helped to sustain the present approach to forward expenditure planning. For example, higher inflation tends to reduce the measured real growth in expenditure because the deflator rises immediately while the (adverse) impact on expenditure is lagged by indexation relationships.

Thus the typically upward corrections to the forecasts of inflation have not tended to pose real difficulties for the Government in meeting its expenditure targets, which are expressed in real growth terms, and indeed have even made their achievement easier. The essence of the problem in this case is, of course, not the setting of correct parameters, but an honest acknowledgment of the underlying problem for which the appropriate policy response could well involve tightening the original real growth target. Somewhat surprisingly, the converse is readily recognized, and an increase in the projected real growth in outlays in response to declining inflation is readily explained away.

RESULTS ACHIEVED

Fundamentally, the real test of the success of Australia’s system of forward expenditure planning will be the results achieved. Judged by the imperative for fiscal restraint, the system has been associated with a remarkable turnaround in the budget over the last six years. And it has been achieved to a significant extent by correcting the structural imbalance. The budget deficit has been converted from a peak level of 4.2 percent of GDP in 1983/84 to a surplus estimated at 2.5 percent of GDP in 1989/90. This has been achieved while the proportion of revenue has risen by less than one percentage point. Thus almost all the burden of restraint has fallen on outlays that have been constrained to fall in real terms for four consecutive years and by 6.3 percentage points of GDP since 1985/86 (see Chart 3).
As the forward estimates are transformed into budget estimates during the budget process, the measure of real growth in the estimates is affected by decisions and other influences, the relative contributions of which for recent years are shown in Table 3. Since 1985/86 the relatively low growth in the forward estimates has been reduced further through the budget process. Ministers' decisions provided the major contribution in the years from 1985/86 to 1987/88, but, in

<table>
<thead>
<tr>
<th>Year</th>
<th>Real Growth (percent)</th>
<th>Change (percentage points)</th>
<th>Contribution from Decisions (percentage points)</th>
<th>Other (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982/83</td>
<td>0.9</td>
<td>1.6</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>1983/84</td>
<td>9.4</td>
<td>-1.0</td>
<td>2.4</td>
<td>-3.5</td>
</tr>
<tr>
<td>1984/85</td>
<td>3.8</td>
<td>2.4</td>
<td>1.0</td>
<td>1.4</td>
</tr>
<tr>
<td>1985/86</td>
<td>3.0</td>
<td>-1.7</td>
<td>-1.1</td>
<td>0.1</td>
</tr>
<tr>
<td>1986/87</td>
<td>2.4</td>
<td>-2.5</td>
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<tr>
<td>1987/88</td>
<td>2.1</td>
<td>-4.6</td>
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<td>-0.3</td>
</tr>
<tr>
<td>1988/89</td>
<td>0.1</td>
<td>-1.9</td>
<td>-0.7</td>
<td>-1.2</td>
</tr>
<tr>
<td>1989/90</td>
<td>-0.7</td>
<td>-0.6</td>
<td>0.3</td>
<td>-0.2</td>
</tr>
</tbody>
</table>
the last two years, there was a somewhat greater reliance on fortui­
tous improvements in the budgeting environment from other influ­
ences, such as movements in economic parameters. Pent-up pres­
ures for the introduction of policies resulted in a significant shift in
the balance between new policy spending and savings, as depicted in
Chart 4. It shows that, after being held down to 0.8 percent of total
outlays in 1987/88, new policy spending rose to 1.2 percent in 1988/89
and 1.9 percent in 1989/90.3 Similarly, the savings effort has declined
from 5.3 percent of total outlays in 1987/88 to 1.9 percent in 1988/89
and 1.5 percent in 1989/90.

Forward planning for savings has arguably led to better decision
making by providing more time and more information to identify
future problems and pressures. The reductions made in outlays
through ministerial decisions are therefore of higher quality, reflect­
ing genuine shifts in policy priorities and improved targeting. This

3Some 0.6 percent of the 1.9 percent increase in spending on new policies in 1989/90
was for improvement in family assistance and was a preferred alternative to further tax cuts
negotiated as part of a wage-tax deal with the unions.
enhanced value for money is most clearly apparent in the area of social security and welfare. The growth rate in this function has been restrained to only 2.2 percent in real terms since 1985/86, compared with about 24.5 percent in the preceding four-year period. Simultaneously, however, funding has been redirected to high-priority programs such as support for low-income families. Major improvements in real per capita benefits have been achieved while the target population has been narrowed to the most needy.

These "quality cuts" have helped maintain the lower growth rates into the out-years, which is apparent in Chart 2. Since 1986, little or no real growth has been built into the forward estimates. The focus on the out-years through forward expenditure planning has been vital to achieving this low growth and thus easing future budgetary tasks. In addition, ministerial cooperation has been enhanced in what are inevitably difficult decisions by the move to top-down budgeting where ministers are asked to meet individual outlay targets in various forms. This at least gives them the incentive that genuine savings found within a portfolio can be allocated according to the portfolio's priorities with relatively little central scrutiny of individual spending proposals. The establishment of reliable forward estimates has been a necessary precondition for meaningful outlay targets.

**CONCLUSION**

When the present Australian Government took office in 1983, it was faced with the need for expenditure restraint. At the same time it wished to achieve a significant reallocation of priorities and to improve public management. It was recognized that this required reforms of the management environment, including the budget process, and that financial management and accountability had to be given a higher prominence. It is doubtful whether either could have occurred without the other. The changes affected relationships within agencies, between central and operating agencies, and between those agencies and ministers.

Publication of the forward estimates was a key early initiative. It both improved public scrutiny and consequently their status. This then led the Government to shift authority for the determination of the forward estimates solely to the Department of Finance, and thus to establish them as the base, and not the subject matter, of the bidding and priority-setting processes. Within this framework, which provided for medium-term planning and overall control of program expenditures, significant devolution was possible. The improved forward estimates have therefore been a major contributing factor to the
progress that the Government has been able to make in its endeavors to improve both fiscal policy and financial management.

The forward estimates have become an important aid for ministers, bureaucrats, and the public to make decisions and judgments about appropriate levels and directions of public expenditure. Their success in achieving restraint depends most importantly on the political environment, but they are part of the process of establishing a conducive environment.

Looking to the future, experience in all countries suggests that the one certainty is that the processes for formulation of the budget can be expected to change. This change is necessary if these processes are to be responsive to changes in the internal dynamics of government, which in turn reflect changing political and economic circumstances. Nevertheless, it is difficult to imagine that future Australian Governments will draw back from the present reliance on forward expenditure planning. Fiscal credibility requires the continued publication of forward estimates and associated analysis and the opportunities that provide for the public to scrutinize the expenditure implications of all government policies and new decisions. Thus, even if political priorities do shift from expenditure restraint, the benefits of the reform of the forward estimates and associated changes in the budget and resource management processes should remain through improved decision making and result-oriented management.

How forward expenditure planning in Australia might be further enhanced is more difficult to foresee. No doubt at the level of some individual programs, greater use could be made of the framework which has now been put in place. Certainly there is room for further improvement in Australia in the area of program evaluation, and the forward estimates provide an important information base in this context. At the macro level the potential of medium-term expenditure planning for reassessing overall priorities has probably still not been fully realized, but this area is difficult. Practical constraints affecting individual programs are the reason why so much of government decision making is done from the bottom up and incrementally. Nevertheless, by planning expenditure over the medium term, there is somewhat greater flexibility and therefore more scope to review priorities. The use of forward estimates for developing a strategic overview of the key issues for resource allocation will therefore be a major challenge for Australian budgeters over the next few years.
APPENDIX

History of Reports of Forward Estimates

Initial Forward Estimates
1965 — Informal projections of current estimates collected from department by Treasury

October 1971 — New guidelines for collection of forward estimates that were to include costing of any new proposals that ministers firmly intended to put forward in the next budget

<table>
<thead>
<tr>
<th>Title</th>
<th>Issue Date</th>
<th>Forward Estimate Years</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unpublished Reports (1973/74-1982/83)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>June 1974</td>
<td>1974/75-1975/76</td>
<td></td>
</tr>
<tr>
<td></td>
<td>April 1975</td>
<td>1975/76-1977/78</td>
<td>Cabinet agreed to upgrade the estimates and to integrate them into the annual budget decision-making process.</td>
</tr>
<tr>
<td>Treasury Report on Forward Estimates of Budget Outlays</td>
<td>March 1976</td>
<td>1976/77</td>
<td>Cabinet decision that officials from the Department of Prime Minister and Cabinet should carry out a review of the forward estimates for 1976/77 to identify possible options for reducing outlays</td>
</tr>
<tr>
<td>Review of Forward Estimates of Budget Outlays for 1977/78</td>
<td>April 1977</td>
<td>1977/78</td>
<td>Same as above</td>
</tr>
<tr>
<td></td>
<td>February 1979</td>
<td>1979/80-1981/82</td>
<td>Forward estimates confined to the costs of maintaining approved ongoing programs and would exclude new proposals.</td>
</tr>
<tr>
<td></td>
<td>February 1980</td>
<td>1980/81-1982/83</td>
<td></td>
</tr>
<tr>
<td></td>
<td>February 1981</td>
<td>1981/82-1983/84</td>
<td></td>
</tr>
</tbody>
</table>
### Published Reports (1983/84–1989/90)

<table>
<thead>
<tr>
<th>Report Title</th>
<th>Date</th>
<th>Fiscal Year</th>
</tr>
</thead>
</table>

Previous reports produced in autumn and served as a scene-setting document for the budget. The second report in November 1986 showed the out-year implications of policies contained in the August budget. Only two forward estimate years published as the budget was intended to be year one.

<table>
<thead>
<tr>
<th>Report Title</th>
<th>Date</th>
<th>Fiscal Year</th>
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</table>

First out-year published in Budget Paper 1 (Statement 3).

Published as part of Budget Statement 3.
Expenditure Controls: Institutional and Operational Issues

A. PREMCHAND

Expenditure controls have gained particular importance during recent years and increased attention to them is only natural in a context of growing fiscal problems. Solutions to current and future fiscal problems clearly require a combination of policy measures and improvements in control techniques and procedures. Although the exact combination of such policy measures and technical improvements depends on the specific situation and type of expenditures, more consideration should be given to the types of controls, the constraints and the environment in which they operate, and their relevance to the ongoing debate. The first part of the paper is devoted to considering the nature of expenditure controls, while the second part considers the practices, current problems, and future directions.

NATURE OF EXPENDITURE CONTROLS

Expenditure controls essentially reflect a managerial process that includes the political and administrative levels and horizontal and vertical relationships within government organizations. Concerns of controls are both with the present in that the immediate budget has to be implemented, and with the future in that the current patterns determine the future shape of the budget through a process of repetitive feedback.

The nature of expenditure controls and their effectiveness are dependent on the external and internal environment of the central and spending agencies in government. The approaches to control are in turn dependent upon the attitude both of the legislature and of public opinion to public spending. Although their views are not always

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1The first part of this paper is extracted from A. Premchand, Government Budgeting and Expenditure Controls (Washington: International Monetary Fund, 1983).
unanimous, the expression of concerns and the broad range of interests have substantial impact on the effectiveness of control. Similarly, the internal relationships between central agencies have considerable and often greater impact than that of public opinion. The budget represents a central concept and reality through which policies are converted into actions. It is in translating goals into actions that issues arise about the most appropriate form through which the joint responsibility of government can be exercised. This, in turn, is dependent on the prevalent value system, the process through which goals are legitimized, and the participants’ adherence to universal rules relating to authority and exercise of power. Power can be both formal and informal; informal power may be more keenly felt than formal power.

Government is made up of many units. Its financial activity involves the working of thousands of decision-making centers and individuals. Given the same purposes and same resources, however, organizations achieve different results. It could be argued, for instance, that the budgetary aims of efficiency and economy are universal and to that extent a common institutional framework would be desirable among various levels of government. In practice, however, this is an impossible task, as each government has a particular environment in which it functions efficiently. This issue cannot be treated in terms of differences between industrial and developing countries, but it is one that is governed by administrative heritage and the interaction of that heritage with economic forces. Notable among such forces are 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 in the effectiveness of expenditure control can be explained in terms of the forces at work that are illustrated in Table 1. To start with, the objectives of government, which in turn influence the approaches to expenditure control, are determined at the political level. Within this framework, more specific programs are evolved by ministries and agencies. In the process of budget formulation, the nature of the partnership between ministries and agencies changes to a vertical one in which the latter work with the former’s guidance—which is appropriate in view of the inherently different responsibilities between spending and central ministries. The ministries are responsible for policies within the limits laid down by government and for the efficiency of their agencies’ work. Central agencies have, on the other hand, the main responsibility for economic and financial policies and the management of the economy. For the spending agency, the budget is an administrative tool. For central agencies, it is a medium for allocating resources and a tool of macroeconomic man-
Table 1. Expenditure Control Framework

<table>
<thead>
<tr>
<th>Control Component</th>
<th>Levels of Decision Making</th>
<th>Allocation</th>
<th>Purposes</th>
<th>Program management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Determination of objective</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Functions or ministries</td>
<td>Political (ministerial)</td>
<td>Political (executive and legislative)</td>
<td>Political (executive and legislative)</td>
<td>Administrative</td>
</tr>
<tr>
<td>Program or agency</td>
<td>Ministerial/administrative</td>
<td>Political/administrative</td>
<td>Mostly administrative</td>
<td>Administrative</td>
</tr>
<tr>
<td><strong>2. Budgetary process</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<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>
</tr>
<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>Administrative (finance, planning, and spending ministries)</td>
</tr>
<tr>
<td>Accounting</td>
<td>Administrative</td>
<td>—</td>
<td>—</td>
<td>Finance and spending ministries</td>
</tr>
<tr>
<td><strong>3. Approaches</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political level</td>
<td>—</td>
<td>Partial identity of interests</td>
<td>Differential interests</td>
<td>Identity of interests</td>
</tr>
<tr>
<td>Administrative level</td>
<td>Central/fragmented</td>
<td>Partial identity of interests</td>
<td>Differential interests</td>
<td>Identity of interests</td>
</tr>
<tr>
<td><strong>4. Problem areas</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Identification of inert areas</td>
<td>Political/administrative</td>
<td>Differential approaches</td>
<td>Differential approaches</td>
<td>Differential approaches</td>
</tr>
<tr>
<td>Cost reductions</td>
<td>Political/administrative</td>
<td>Identical approaches</td>
<td>Identical approaches</td>
<td>Identical approaches</td>
</tr>
<tr>
<td><strong>5. Control trends</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normal periods</td>
<td>Decentralized approaches</td>
<td>Decentralized approaches</td>
<td>Decentralized approaches</td>
<td>Decentralized approaches</td>
</tr>
<tr>
<td>Crisis periods</td>
<td>Centralization</td>
<td>Centralization</td>
<td>Centralization</td>
<td>Centralization</td>
</tr>
</tbody>
</table>
agement. The central responsibility can be discharged by these agencies only through the budgets and activities of the spending agencies. It is the acceptance of this crucial relationship that has over the years endowed additional powers initially in finance and later in planning. This relationship has also enabled finance to generate power and to be the recipient of power generated at other levels. A budget agency or finance ministry cannot work like a military mission, and the degree of cooperation it receives and the success of its own operations are dependent on the perceptions of other agencies. There is a partial identity of interests in the allocation stage at the political and administrative levels, while in the context of stabilization it is likely that different interests will emerge among central and spending agencies because of different perceptions of what can and what should be reduced. Similar issues arise in the vertical relationships between ministries and agencies. Differences in perception and in advocacy would arise, both horizontally and vertically, in the identification of inert areas. Spending agencies often attach greater importance to their programs, which may not have the same priority on a national scale.

Once areas of obvious wastage are identified and methods to reduce them are established, there will be greater identity of interests. The purposes are better served and a more cohesive control system emerges when objective criteria are determined. Where output measures and cost indices are available, control can be based on objective factors and thus becomes less biased. Similarly, traditional factors may encourage 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 act differently. The possibility of conflicts therefore is as large as the entire budgetary process.

Different systems seek to resolve these conflicts in different ways. In the United States, there is considerable decentralization of power among spending agencies that have complete operational freedom within approved budgets. In some European systems spending ministries have substantial independence. In the French system, spending ministries have greater responsibilities for policy formulation than for financial and accounting controls, which are traditionally handled by officials of the finance ministry. In Italy and Latin America also, the general accounting offices exercise financial and accounting controls. In the United Kingdom and Commonwealth countries, accounting controls are largely exercised by the personnel of the finance ministry, while the policy and financial controls have devolved on spending ministries. 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 wider acceptance. It was recognized that separating these two functions could adversely affect financial management and might imply policy formulation uninfluenced by resource constraints. Administrative and financial responsibilities reflect two sides of the same phenomenon and both should be preserved. In some Commonwealth countries (notably India), the gradual devolution of financial responsibility was achieved through a system of 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 had an ambivalent role of serving both finance and spending ministries, were later expected to serve only the latter.

It could be argued that the relationship between finance and spending agencies has been cyclical. In earlier years, when governments were small and their tasks more manageable, finances were centrally controlled by royalty or their trusted representatives. With the growth of government, authority was gradually decentralized to spending agencies subject to the observance of specified general principles. Such decentralization suited the managerial requirements and helped the implementation process. In some countries the pace of decentralization was speeded up by the emergence of coalition politics. Later, these centrifugal tendencies suffered some reversal and centripetal forces emerged again, largely reflecting the requirements of a coherent economic management program. Administering finely tuned economic management policies demanded a greater degree of centralization. Periodic recurrence of 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 ministries to look for possible economies. In Canada an Office of the Comptroller General was set up for the whole government. In the United States, drawing on the parallels of European practices, inspectors general of finance were appointed selectively in spending departments. But in developing countries, particularly those at an early stage of administrative development, the endemic shortage of trained manpower contributed indirectly to strengthening the inherited centralized framework.

The significant issues that emerge from the existing systems of expenditure controls may be broadly examined according to the relevance of control by direction, control by inducement or by a system of incentives, control by concertation, and the appropriate mix of policy and machinery. Control by direction implies a strong central agency responsible for the economic management of the country that will
accordingly provide guidance to numerous decision-making centers on their responsibilities. It is often suggested that central direction facilitates a coherent view of government policies, decision making, and implementation. The smooth functioning of control by direction creates certain organizational features and essential policy inputs. Organizationally, it should have a capable staff that can provide direction to the different areas of government. From a budgetary policy angle, the equation between inputs and outputs and information about costs should be available to the directing agency so that precise directions can be given. In practice, however, such central direction proved difficult and, as noted earlier, decentralization was adopted. Centralization stretched the limits of organization and became, after a certain point, dysfunctional. Furthermore, such control often became illusory as the lines of communication were unclear and as reality differed considerably from intent. Since budgetary systems had not developed sufficient data on input and output relations and costs, central agencies were content to specify acceptable behavior in the spending agencies, which in practice took the form of accounting controls. Excessive dependence on central agencies made the spending agencies become inert and made 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 approaches 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 formulating policies and that implementation should be left to the spending agencies. Another is that the objectives of government should be stated clearly and periodically, while yet another is that the role of central agencies should be confined to pre-budget scrutiny. The first and the third suggestions reflect variations on a theme. The purpose of the second suggestion is met in practice through medium-term development plans or financial forecasts and they have 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, as spending agencies were more eager to pursue policies than to consider their financial consequences, a handicap emerged that was in some measure due to the halfhearted implementation of decentralization. Moreover, spending agencies continued to rely on finance and found it to be a convenient feature of “redundancy” or a back-up system. In countries where decentralization is a systemic feature, it appeared that a reverse dependence had developed in that the central agencies had to rely on the spending departments for many of their operations. If the failure to delegate financial powers
swamped the central agencies with enormous workloads and a range of issues that may exceed their analytic capabilities—effectively contributing to the nondevelopment of financial management within spending units—it appears that liberal decentralization is also not without problems, as it reduces the capabilities of central agencies in carrying out their tasks. While part of the latter problem was somewhat mitigated by the introduction of central information systems, problems still persist in both lines of approach.

Recognition of the drawbacks of control by direction has contributed to the advancement of the theme of control by incentives. It should be noted that this framework is largely theoretical and is not yet fully refined. Charles Schultze (former Director, U.S. Bureau of the Budget), who earlier did much work in this area, recognized that the success of most 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 are reaped by the intended beneficiaries—the community. For both these factors to contribute to the success of programs, Schultze suggested that incentives should be included in the program design and in the formulation of the budget itself. For example, government irrigation programs can have appropriate tax and subsidy strategies to induce the agriculturalist to utilize the benefits. Similarly, certain average costs of services can be specified and those agencies that perform well can be appropriately rewarded. Schultze does not suggest that the whole range of government programs should be redrawn along these lines. On the other hand, this suggestion was to be applied selectively and as a supplemental measure to traditional expenditure controls.

The introduction of incentives to government would require specifying outputs, costs, and measures of performance—all areas in which a good deal of progress remains to be made. Two other limitations to this approach should be noted. First, it changes the nature of financial control from a bureaucratic technique to a broad-based philosophy that intends 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, the provision of incentives to government employees outside normal career opportunities is a difficult exercise. Such incentives do exist, ironically, in centrally planned economies like those of Eastern Europe (now in transition). Notwithstanding these limitations, the selective application of this approach is worth exploring further.

Like the above, control by concertation is also an approach that has been applied only occasionally. Basically, it is recognized that central controls have grave implications while a decentralized system is not fully compatible with the central responsibilities of finance and plan-
ning agencies. This approach views the relationship between finance and spending agencies as one of joint work in a common enterprise or a mutually compatible framework. The Plowden report in the United Kingdom pleaded for a "right balance and differentiation of function" in the unique relationship between these two kinds of agencies. The technique of control by concertation emphasizes that mutual consultation between finance and other agencies is an essential base for formulating policies and functioning of controls. Such consultation should contribute to greater realism in central policies and to a more effective functioning in the agencies. But the practical experience of this technique appears to have been limited to periods of financial crisis. It may be appropriate to consider its application during normal times as well.

In the exercise of expenditure controls, an important aspect relates to the balance between policy measures and control techniques. In most programs, the role of the latter is peripheral and much depends on the policy premises. An 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 mechanisms and use of them to compensate for policy shortcomings could overload the machinery, build up undue expectations about their efficacy, and, when the realities are known, lead to frustration and a general condemnation of controls. In such an atmosphere, public attitudes become even more critical and a pervasive feeling may 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 control and techniques, and their mutual complementarity.

PRACTICES AND PROBLEMS

Over the years, budgetary systems and their concomitant expenditure courses have grown from the accountability to the management and planning stages. In the process, the systems also provided responses to the changing economic imperatives and philosophies. Some of these developments are shown in Table 2. In a more practical context, it appears that expenditure control systems have gone through six phases during the last four decades. First, a number of countries that became independent from the late 1940s to the late 1960s essentially had systems that were a legacy of the colonial past. A prominent feature of these systems was the dominant role played by the ministry of finance and the considerable reliance placed on repetitive accounting controls. Second, while these systems contin-
<table>
<thead>
<tr>
<th>Budget Systems and Models</th>
<th>Classical Budgeting</th>
<th>Keynesian Model</th>
<th>Rational Restraint Model (1960s)</th>
<th>Budgeting in 1980s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central tenet or underlying notion</td>
<td>Annual balanced budget and accountability</td>
<td>Balanced economy</td>
<td>Balanced society</td>
<td>Balanced society</td>
</tr>
<tr>
<td>Basic values</td>
<td>Governments should be prudent and run like a household</td>
<td>Governments should be prudent and proactive over business cycle</td>
<td>Just society and active government</td>
<td>Government viewed as the problem. “Smaller governments and less state intervention” is the preferred solution.</td>
</tr>
<tr>
<td>Core ideas of restraint</td>
<td>Honesty, probity, and fiscal rectitude</td>
<td>Stability and counter-cyclical activity</td>
<td>Rationality in decision making and application of quantitative techniques of analysis</td>
<td>Trust in the superiority of market mechanisms in producing and allocating most goods and services</td>
</tr>
<tr>
<td>Officials involved</td>
<td>Accountants, controllers, auditors, and clerks</td>
<td>Predominant influence of economists</td>
<td>Policy analysts, planners, and advisers</td>
<td>“Value-for-money” auditors, program evaluators, and efficiency consultants</td>
</tr>
<tr>
<td>Typical methods and techniques</td>
<td>Pre-audit, internal audit, and detailed controls and checks</td>
<td>Automatic stabilizers</td>
<td>Goal-setting and priority-setting exercises, new budget systems and methods (performance, PPBS, zero-based budgeting, management by objectives (MBO), management by results (MBR), O and M techniques)</td>
<td>Privatization, deregulation, sunset provisions, spending and tax limits, and related policy measures</td>
</tr>
</tbody>
</table>

1Adapted from Allan M. Maslove, Michael J. Prince, and G. Bruce Doern, Federal and Provincial Budgeting (Toronto: University of Toronto Press, 1986), p. 206
ued, albeit with minor and major changes, planning systems also emerged that were envisaged as instruments to formulate and implement development plans. This factor contributed to a frequent division of power between finance and planning ministries, rivalries between the two, and to even further fragmentation of decision making and control of budgets. Third, more recently, the boom in oil revenues in oil producing countries contributed to new and greater compulsions for spending more money, which in turn paved the way for minimizing central controls and for creating extensive autonomous funds that in effect contributed to the phenomenon of the disappearing budget. The impact on oil importing countries was often the converse of this experience. Fourth, again more recently, countries with substantial buildup in their external debt had to resort to strong, centralized control systems aimed at facilitating fiscal adjustment to this new situation. Fifth, the combined impact of inflation, a deterioration in the balance of payments position, and growing unemployment induced many countries to choose the path of structural adjustment with orderly management of public expenditures. This situation in turn demanded an improved expenditure control system aimed at compliance with specified policy goals. And finally, countries that had started with centrally planned economies have begun to relax their hold and have shown greater response to market signals—a situation which in turn imposed new challenges on these systems. The present situation, however, is one that shows the cumulative impact of all these stages.

The response of countries and of systems to the changing requirements is illustrated in Tables 3, 4, and 5. Table 3 shows the improvements in the systems of public expenditure management in selected OECD countries. Tables 4 and 5 capture these developments in terms of features and facets of financial management systems. Tables 2-4 show the general systemic problems as well as responses to changing requirements.

Problems come alive through a systematic interaction between events and individuals. These systemic responses are not yet universal. Even where improvements were implemented, the process of implementation itself may have contributed to more, albeit different types of problems. If a meaningful strategy of public expenditure management is to be evolved, the current problems need to be identified first. These problems differ from one country to another and from one budgetary context to another. To that extent, their incidence is not uniform.

Broadly, the institutional and systemic landscape of the public expenditure management systems reveals five major problem areas.
<table>
<thead>
<tr>
<th>Area</th>
<th>Australia</th>
<th>Belgium</th>
<th>Canada</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Policy goals</strong></td>
<td>Commonwealth budget outlays, tax revenue, and deficit are not allowed to grow as percentage of GDP. (This commitment is known as “trilogy”.)</td>
<td>Budgetary targets including those for social security contributions and public debt are agreed as a part of the coalition of parties forming Government.</td>
<td>A new system known as Policy and Expenditure Management System (PEMS) was introduced to facilitate an analysis of the implications of current policies for revenues and expenditures and for overall fiscal policy. A major policy tenet is to keep the rate of growth of program expenditures below the rate of inflation.</td>
<td>The aim since 1983 has been to maintain zero real growth in public expenditure.</td>
</tr>
</tbody>
</table>

| **2. Public expenditure planning** | Preparation of forward or multiyear estimates (MYEs) | Publishes forward estimates for the budget year and two forward years. These are based on forecasts of macroeconomic parameters. Outlays are forecast on a present policy basis. | Although no MYEs are prepared, each ministry prepares a report on unchanged policy expenditure levels. Further, to facilitate an improved analysis, expenditure is now divided following a goals-oriented approach into subsistence programs (general administrative costs) and specific activity programs (covering major tasks). | MYEs are only published for expenditure and non-tax revenues. They are based on the price and pay levels of the budget year. The degree of detail is the same as in the annual appropriations. |
3. Budget formulation

(a) Formulation of priorities, guidelines, resource ceilings, etc.

In the light of above estimates, Government sets its overall strategy, including determination of total expenditure, priority-setting for portfolio budgets. Government departments and organizations are divided into 28 portfolios. Both general and specific guidance is provided in the formulation of portfolio budgets.

(b) Review of efficiency and effectiveness

To strengthen budget formulation that focuses on what expenditures should produce, a Financial Management Improvement Program (FMIP) has been introduced. It emphasizes the results achieved as well as consideration of “savings options.” FMIP seeks to provide a corporate approach to management.

(c) Personnel control

Staff planning and financial planning have been integrated to forge a stronger link between objectives and programs.

It is expected that sectoral priorities are reviewed in the light of overall government priorities and policies. The top-down (fiscal planning) and bottom-up (expenditure management) are interactive, contributing to mutual adjustments. A result of fiscal planning is the determination of policy sector envelopes.

With a view to facilitating review of efficiency, the operations of Government are divided into 300 planning elements and the resource allocations to the elements are expressed as reference levels—i.e., financial and human resource levels. These levels take into account workload factors and other indicators.

Reference levels explicitly include numbers of personnel needed to operate approved programs.

Manpower limits are imposed as an integral part of expenditure limits.

Broad policy areas are reviewed once in four to five years. Although there are no formal links to the budget cycle, Budget Department participates in these reviews.

In the light of the published targets for expenditure, Finance Ministry proposes, after bilateral probes, one-year spending limits. Once fixed, all changes (e.g., cost changes) within an allotted block must be met through internal adjustments. Major limits are imposed on discretionary expenditure other than entitlement programs.
<table>
<thead>
<tr>
<th>Area</th>
<th>Country</th>
<th>Australia</th>
<th>Belgium</th>
<th>Canada</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Budget implementation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Release of funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Spending departments prepare three reports during the year on the spending developments and possible overruns. If overruns occur, offsetting cutbacks (including mobilization of more nontax revenues) are envisaged.</td>
</tr>
<tr>
<td>(b) Cash limits</td>
<td></td>
<td>Cash limits have been in force since 1984/85.</td>
<td></td>
<td></td>
<td>Overall monthly cash requirements are forecast and monitored for purposes of the Government’s debt management program.</td>
</tr>
<tr>
<td>(c) Improved financial management in spending agencies</td>
<td></td>
<td>Departments are being given more responsibility and flexibility to manage allotted resources. To facilitate this approach, appropriation structures were simplified.</td>
<td></td>
<td></td>
<td>A new program known as Increased Ministerial Authority and Accountability (IMAA) is being implemented. In recognition of the possible disincentive effects of highly centralized controls, IMAA stresses improvements in departmental flexibility to accompany tighter controls over total resources.</td>
</tr>
</tbody>
</table>

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### 5. Accounting and management information

<table>
<thead>
<tr>
<th>(a) Strengthening of EDP systems</th>
<th>This area was strengthened substantially and data are available for all transactions on a current basis.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Monitoring in spending and central agencies</td>
<td>A management information system has been installed to keep track of transactions, to help managers assess the results, and to keep them in tune with economic conditions that affect program operations.</td>
</tr>
</tbody>
</table>

- These transactions have been on an EDP basis for some years.
- Regular monthly accounting statements are prepared centrally but are not rigorously monitored by the Treasury Board. As a general rule, departments are not expected to exceed annual appropriations.
- See item 4 above. Efforts are now being made to introduce concepts of corporate management and decentralized budget and accounting systems in government.
<table>
<thead>
<tr>
<th>Area</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Policy goals</td>
<td>Finland</td>
</tr>
<tr>
<td></td>
<td>The aim since 1985 has been to restrict annual real growth rate to less than 2 percent.</td>
</tr>
<tr>
<td>2. Public expenditure planning</td>
<td>France</td>
</tr>
<tr>
<td></td>
<td>Norms include central government deficit as a ratio of GDP (not to exceed 3 percent) or to be in excess of interest payments.</td>
</tr>
<tr>
<td></td>
<td>Germany, Fed. Rep. of Ireland</td>
</tr>
<tr>
<td></td>
<td>The intentions are to limit the nominal growth of expenditure of the Federal Government and to reduce its net borrowing requirement further.</td>
</tr>
<tr>
<td></td>
<td>Ireland</td>
</tr>
<tr>
<td></td>
<td>The medium-term economic plan (1984) specifies several targets, e.g., current budget deficits; exchequer borrowing requirement; and public sector borrowing requirement.</td>
</tr>
</tbody>
</table>

MYEs are prepared for the budget year and five future years and are updated every second year. The medium-term expenditure plans are based on current policies and new investment measures as well as new legislation. No comprehensive system of MYEs. MYEs are prepared for expenditures, revenues, and deficits. These estimates are prepared as a part of medium-term financial plan covering a five-year period. MYEs are updated every year. Annual planning includes a given ratio of expenditures as a general planning reserve. There is no formalized system of detailed medium-term expenditure allocations. Although the estimates are included in the medium-term plan, they are subject to changes in annual budget.
3. Budget formulation
(a) Formulation of priorities, guidelines, resource ceilings, etc.
On the basis of medium-term expenditure plans and with reference to macroeconomic targets, annual informal ceilings are indicated to agencies by the Ministry of Finance.

(b) Review of efficiency and effectiveness
No formal procedures, but medium-term expenditure planning process includes reviews of selected activities.

(c) Personnel control

4. Budget implementation
(a) Release of funds
Reforms are being proposed to achieve improvements in the system of accounting and disbursement.

(b) Cash limits
Traditional controls: no recent innovations.

(c) Improved financial management in spending agencies
When expenditure is likely to exceed the authorized total, Finance Minister may make commitments or expenditures subject to his approval.

In the light of a review of the economy, guidelines are issued by the Department of Finance setting out parameters for preparing estimates of expenditures.

This review is undertaken from time to time by special committees appointed for the purpose. The objective is to achieve expenditure savings through the termination of outmoded programs. The Government is now endeavoring to formulate criteria for improving its productivity.

Selected departments are required to submit a profile of expenditure for each month. They are then monitored on a regular basis. Excess above the monthly estimate has to be offset by compensating measures in the following months.
<table>
<thead>
<tr>
<th>Area</th>
<th>Country</th>
<th>Finland</th>
<th>France</th>
<th>Germany, Fed. Rep. of</th>
<th>Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Accounting and management information</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Strengthening of EDP systems</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Monitoring in spending and central agencies</td>
<td>Finland</td>
<td>The financing needs of major expenditure items are forecast on a monthly basis for the year and the outcomes are monitored by the Ministry of Finance.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Germany, Fed. Rep. of</td>
<td>An automated procedure of budget execution is being implemented. It covers all the phases of receipts and expenditures of the federal budget.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Ireland</td>
<td>The Government is now formulating a plan to improve financial management through modern information technology.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area</td>
<td>Italy</td>
<td>Japan</td>
<td>Netherlands</td>
<td>Norway</td>
<td></td>
</tr>
<tr>
<td>-------------------------</td>
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<td>----------------------------------------------------------------------</td>
<td>------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>1. Policy goals</strong></td>
<td>The intent is to stabilize the Treasury Borrowing Requirement in nominal terms.</td>
<td>The tentative policy targets include reduced dependence on deficit-financing bonds and reduction of public debt (as a percentage of general account budget expenditure) by fiscal year 1990.</td>
<td>There are budgetary targets for deficit and revenues. They are expressed as percentage of net national income. (See also item 3(b) below.)</td>
<td>Several indicators, such as government budget balance before loan transactions, and budget balance excluding oil sector, and budget balance contribution to monetary growth, have been developed to provide a policy backdrop for the budget.</td>
<td></td>
</tr>
<tr>
<td><strong>2. Public expenditure planning</strong></td>
<td>MYEs are of two types: one is a trend version (projection of revenues and expenditures under current policies); another is a &quot;planning scenario&quot; version. MYEs, updated annually, generally cover a period of three years and are based on commitments.</td>
<td>No formalized system of MYEs.</td>
<td>MYEs are prepared both for expenditures and nontax revenues of Central Government. They are used as a means of control by the Ministry of Finance and do not contribute rights for the spending ministries.</td>
<td>MYEs are prepared for central government expenditure for three years beyond the budget year.</td>
<td></td>
</tr>
</tbody>
</table>
Table 3. Recent Improvements in Public Expenditure Management in Selected OECD Countries (continued)

<table>
<thead>
<tr>
<th>Area</th>
<th>Country</th>
<th>Italy</th>
<th>Japan</th>
<th>Netherlands</th>
<th>Norway</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Budget formulation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Formulation of priorities, guidelines, resource ceilings, etc.</td>
<td></td>
<td></td>
<td>Initial guidelines are provided by the Finance Ministry. Actual provisions in the budget are subject to usual negotiations between spending agencies and Ministry of Finance.</td>
<td>Ministry of Finance formulates proposals for the allocation of resources, including the extent of cutbacks needed for the year. These proposals then provide the parameters for the estimates to be prepared by the agencies.</td>
<td>Preliminary ministerial spending limits are indicated to the agencies.</td>
</tr>
<tr>
<td>(b) Review of efficiency and effectiveness</td>
<td></td>
<td></td>
<td>These reviews are undertaken by departments within a framework of three principles: (1) scrap and build—new measures in lieu of existing ones; (2) subsidy programs should have a termination period of five years; and (3) annual limits placed on budget requests.</td>
<td>Since 1981, a new procedure known as “Reconsiderations Procedure” has been in operation. It essentially seeks exploration of alternatives with a mandatory 20 percent funding level reduction as one option. From 1983, this procedure has been made an integral part of the budget cycle and process.</td>
<td>These reviews are undertaken by the Ministry of Finance in formulating annual spending limits.</td>
</tr>
<tr>
<td>(c) Personnel control</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4. Budget implementation

(a) Release of funds
(b) Cash limits
(c) Improved financial management in spending agencies

5. Accounting and management information

(a) Strengthening of EDP systems
(b) Monitoring in spending and central agencies

New procedures called "Rules of Stringent Budget Policy" have been introduced. In terms of these procedures, excess expenditures have to be compensated by corresponding reductions. In some cases, prior approval by the Minister of Finance may be needed even after legislative approval of the budget. It is also proposed to monitor commitments regularly. Some experiments have been initiated recently.

Spending agencies may exceed appropriated levels to cover estimate failures or to finance new policy initiatives. Annual budget contains a reserve for the purpose.

Ministry of Finance reviews the trends in actual expenditures every two months. Parliament is informed twice a year.

See item 4 above.
<table>
<thead>
<tr>
<th>Area</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Policy goals</td>
<td>Sweden</td>
</tr>
<tr>
<td></td>
<td>Policy targets include a reduction in the expenditure/GDP ratio.</td>
</tr>
<tr>
<td>2. Public expenditure planning</td>
<td>Turkey</td>
</tr>
<tr>
<td></td>
<td>Annual budgeting is done within the framework of the five-year plan, which also specifies ratio of total public expenditure to GNP.</td>
</tr>
<tr>
<td></td>
<td>United Kingdom</td>
</tr>
<tr>
<td></td>
<td>Government's budgetary policy is developed in the context of its Medium-Term Financial Strategy (MTFS). A major policy goal is a reduction in the public sector borrowing requirement.</td>
</tr>
<tr>
<td></td>
<td>United States</td>
</tr>
<tr>
<td></td>
<td>Reduction of budget deficit is the aim of both executive and legislative wings.</td>
</tr>
</tbody>
</table>

Notes:
- MYEs = Multiyear Expenditure Statements
- GNP = Gross National Product
- MTFS = Medium-Term Financial Strategy
- FY = Fiscal Year
- % = Percentage
- Ø = Approximately
- $ = Dollars
- % = Percentage
- FY = Fiscal Year
- Ø = Approximately
### 3. Budget formulation

<table>
<thead>
<tr>
<th>(a) Formulation of priorities, guidelines, resource ceilings, etc.</th>
<th>Guidelines are issued in the light of a review of macroeconomic variables.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Review of efficiency and effectiveness</td>
<td>The Central Agency for Administration Development reviews government programs periodically.</td>
</tr>
<tr>
<td>(c) Personnel control</td>
<td>Personnel costs are now budgeted more in financial resources than in numbers of staff. Provisions made for wages and salaries cannot exceed a certain maximum.</td>
</tr>
</tbody>
</table>

There is an annual public expenditure survey and in the light of this survey indicators are given to spending agencies, which are then negotiated for eventual inclusion in the budget.

There are "efficiency scrutinies" in each department. Treasury monitors these developments.

The existing legislation relating to deficit reduction and the annual guidelines provided by the Office of Management and Budget help the spending agencies in formulating their estimates.

This effort is largely internal to the operating agencies.
Table 3. Recent Improvements in Public Expenditure Management in Selected OECD Countries (concluded)

<table>
<thead>
<tr>
<th>Area</th>
<th>Sweden</th>
<th>Turkey</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Budget implementation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Release of funds</td>
<td>Budget implementation in general is more closely followed by the National Audit Bureau than by the ministries or the Ministry of Finance.</td>
<td>Ministry of Finance exercises a commitment control. In addition, it maintains a reserve and an Investment Acceleration Fund (amounting to 3 percent of total appropriations) that are used as emergency reserves for current and capital expenditures, respectively.</td>
<td>There is a traditional system of exchequer issues administered by the Paymaster General.</td>
<td>Funds are released in terms of quarterly apportionments.</td>
</tr>
<tr>
<td>(b) Cash limits</td>
<td>Government can withhold funds appropriated by Parliament. Also, in some cases, excess expenditures are permitted. Further, there is a reserve to protect the projected budget deficit against unforeseen changes.</td>
<td>—</td>
<td>There is also a system of cash limits applicable to (a) pay and other &quot;running costs&quot;; (b) defense budget and hospital services; and (c) grants to institutions and other levels of Government. Certain commitments are subject to prior approval by the Treasury.</td>
<td>Budget limits cannot be exceeded. In some cases legislation itself provides authority for transfer of funds within programs.</td>
</tr>
</tbody>
</table>
5. Agencies have defined financial management, which differs from traditional spending by agencies.

### Agencies:
- **Independent Budget:** They have a budget that is not directly controlled by the Treasury, allowing for more flexibility.
- **Partial Budget:** These agencies have a budget that is only partially controlled by the Treasury, providing some autonomy.
- **Restricted Budget:** These agencies have a budget that is heavily controlled by the Treasury, with minimal autonomy.

### Monitoring:
- **Ministry of Finance:** Monitors financial transactions monthly.
- **Office of Management and Budget:** Regularly monitors agencies, providing feedback on performance.

### Information Systems:
- **Strengthening of EDP Systems:** Modernized in recent years, data available simultaneously to spending agencies and the Treasury.

### New Financial Management:
- **Agencies:** Manage their own financial affairs, with a new financial management system.

### Sources:
Table 4. Features of Government Financial Management Systems

<table>
<thead>
<tr>
<th>Area</th>
<th>Approaches</th>
<th>Organizational Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget formulation</td>
<td>Expenditure planning for short and medium term</td>
<td>Consensus building</td>
</tr>
<tr>
<td></td>
<td>Policy guidance through specification of ceilings, envelopes, or portfolios</td>
<td>Education of the public</td>
</tr>
<tr>
<td></td>
<td>Staff ceilings</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Scrutinies or reviews of program</td>
<td>Investment in analysis</td>
</tr>
<tr>
<td></td>
<td>Review of efficiency and productivity</td>
<td>Centralization of selected functions</td>
</tr>
<tr>
<td>Budget implementation</td>
<td>Commitment controls</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash management</td>
<td>Improvement of financial management capability in spending agencies</td>
</tr>
<tr>
<td></td>
<td>Cash limits</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Value-for-money audit</td>
<td>Introduction of EDP systems</td>
</tr>
</tbody>
</table>

Table 5. Four Facets of Budgetary Systems

| Incremental budgeting   | Predictable budgetary contexts                      |
|                        | Incremental changes                                  |
|                        | Traditional analysis of changes                      |
|                        | Organizational balance largely intact                |
|                        | Largely a bottom-up budget                           |
| Medium-term expenditure planning | Analysis of resource requirements and use over the medium term on a rolling basis |
|                        | Provision of contingencies for unforeseen situation |
|                        | Greater role for groups of spending agencies         |
|                        | Improved coordination between revenues and expenditures |
|                        | Organized cutback management                         |
| Efficiency budgeting   | Promotion of cost consciousness                      |
|                        | Cost measurement and containment                     |
|                        | Improvement of productivity                          |
|                        | Spending to save                                     |
|                        | Improved financial management in spending agencies   |
| Crisis budgeting       | Ceilings and resource allocations frequently adjusted |
|                        | Uncertain budgetary process                          |
|                        | Cuts imposed on an ad hoc basis and across the board |
|                        | Centralized payments and restrictions on payments    |
|                        | Arrears accumulation                                  |
|                        | Neglect of several areas in resource allocation      |
|                        | Budgets reflect a mix of top-down and bottom-up approaches |
|                        | Severe strain on financial managers                   |

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The systems have been less than adequate to meet the requirements of macroeconomic management. There is a frequent lack of congruence between resource and expenditure planning. Indeed, the two appear to follow two different paths. Planning and management of uncertainty remain to be internalized in the budgetary process. Efforts to measure costs have not yet met with success. Accounting and fiscal reporting continue to be major bottlenecks. More specifically, the following problems arise:

- At a policy level, efforts to reduce expenditure have not been successful because each time program expenditures are reduced, they seem to increase more than previously, in a short time. In addition, the effort seems to have run out of steam and needs renewed energy.
- When efforts to reduce expenditures have been made, the burden of adjustment has been uneven and appears to have fallen mostly on capital expenditures (particularly housing and transfers). Operational and maintenance expenditures for completed projects have also suffered extensively.
- A control dilemma has also emerged. Governments responsible in the past for pursuing social welfare measures are insecure about reducing expenditures that might lead to these benefits being curtailed or to the burden being raised through additional mobilization of resources. A necessary consequence of this approach has been the emergence of what was termed "uncontrollable outlays."
- At an institutional and systemic level, as a result of a failure to reckon with economic uncertainty, budgets are now frequently submitted much later in the fiscal year.
- There is little budgetary guidance to the spending ministries and agencies.

The impact of the above problems is particularly felt in centralization or in elaborate management control systems and in approaches to crisis management.

In an endeavor to provide cheaper and improved results—which is after all the main purpose of expenditure management systems—elaborate control systems have been devised over the years. In summary, the systems have, from a structural point of view, passed through four distinct phases. The first stage was a highly centralized administration, as governments were generally small. It was as a part of this system that controls were exercised by central agencies, both during budget formulation and budget implementation stages, as
well as in the payment stages. Then, this stage yielded in time to one
where these controls were reduced and an arms-length relationship
between the central and spending agencies was found convenient.
Later, with economic management as the dominant policy force, a
framework of intervention or selective policy changes in the budget
during the year emerged as another facet of control. The fourth stage
is one where the normal day-to-day management of financial matters
by spending agencies is assumed by the central agencies.

The present stage in a number of countries closely resembles this
fourth phase of control. This has not been without cost. Along with
the loss of financial consciousness in the spending agencies, the elabo­
rate systems of control became cumbersome, rigid, stultifying, and
burdened with red tape, which in turn appears to have had an ad­
verse impact. Efforts to control waste or abuse of authority have
become diffuse and lacking in accountability.

Further, the approaches to crisis management have been tactical
rather than strategic. The latter implies a basic sense of direction and
consists of the determination of objectives, changes in these objec­
tives, the resources needed for achieving them, and the policies that
are to govern the acquisition and use of those resources. Tactical, on
the other hand, refers to changes in position without notice and
sometimes in a reverse direction. Tactical approaches do not antici­
pate crises but deal with them as they occur and, if experience is any
guide, appear to contribute to another crisis while smothering the
current one.

INTO THE 1990S AND THE NEXT MILLENNIUM

The tasks of the next decade are to redress the above problems, to
compensate for them, and to inoculate against or otherwise overcome
them. In addition, more detailed consideration needs to be given to
the following.

Public Money and Private Works

Although a part of government work is traditionally carried out
through contracts, owing to the recent emphasis on privatization it
appears that even those activities that were thought to be a govern­
ment’s preserve would now also be carried out through contracts.
These contracts, when undertaken in a competitive context, could
work in favor of governments financially. Where, however, contract
rigging and monopolistic practices prevail, they may prove more
costly for governments. In either event, the objective of control would
be to derive value for money with the quality of work maintained at the desired levels. The issue to be considered is what additional orientation can be given to expenditure controls to ensure that contracting out services would not necessarily lead to the creation of domains of patronage.

**Allocational Problems**

Allocative efficiency requires that a balance is maintained between receipts and expenditures and among various government functions and programs in each function. The crux of the allocative problem is that despite the pursuit of various paradigms over the years and shifting involvements from time to time, the achievement of balance among functions and programs remains elusive. This may be ascribed, in turn, to three factors. First, either because of political forces or other factors, financial controls at a policy stage have tended to weaken over the years. Establishment of autonomous funds, and the relinquishing of consensus-building procedures have exacerbated the problem. Second, the budgetary processes tended to narrow as government loans, tax expenditures, and others were sometimes considered outside the processes. Third, the annual budget making became a somewhat perfunctory exercise with little flexibility in allocations and with frequent adjustments made after the announcement of the budget by resort to formula strategies. The net result is not merely a loss of allocative efficiency in the immediate context but also a probable introduction of additional distortions in the economy. The issue then is how can expenditure control be strengthened to improve allocation of resources. It is not merely a choice among program, object, chapter-oriented, or double-entry budget approaches but it is essentially one of proper use of these techniques.

**Control of Personnel**

Until the early 1950s, personnel positions in government were centrally controlled by finance ministries. But with the growth of program budgeting this function was gradually devolved to spending departments to facilitate an integration of policy, program, and personnel managements. But as government tasks and the government civil service grew, and confronted by the need for economy, some of the delegated powers were reduced and in some cases efforts were even made to recentralize the personnel control function in the finance ministries. The present situation, however, is that civil service growth continues even in industrial countries, while the phenome-
non of "ghost employees" has emerged as a major problem in some developing countries. The issue that will re-emerge in the next decade and thereafter will be the design of a control system that would be more effective in this regard while permitting adequate flexibility to program managers. Some recent developments in Australia and New Zealand show promise for an improved personnel control system. What relevance do these developments have for other countries and systems?

**Controlling Budget Implementation**

Budget implementation appears to have been adversely affected in a number of countries by archaic budget laws; repetitive accounting controls; lack of reconciliation of the requirements of central agencies with those of program managers; excessive centralization in awarding contracts and making payments; and lack of differentiated control systems. While the evidence of these problems differs from one country to another and from one context to another, the important consideration is that whereas control during implementation should aim at ensuring that funds are properly spent, it has in fact become a process in search of a rationale. Control mentality has replaced achievement orientation. The perfunctory use of administrative procedure was more important than improving a course of action that in turn contributes to overall economic management. The issues then are whether these controls could be rendered more purposeful and whether they could be designed to differentiate money-intensive transactions from labor- and capital-intensive transactions.

**Centralization and Decentralization**

It should be recognized that centralization by itself need not necessarily be a problem; nor, however, is decentralization a solution to all financial management problems. From a highly centralized system of control, a steady devolution of powers and responsibilities to spending agencies occurred. While such a trend was inevitable, given the growth and complexity of expenditures, EDP systems also made a substantial contribution by permitting simultaneous access to information. Moreover, recent efforts, such as the financial management initiative, have also contributed to further decentralization. But the main problem is that communication of resource realities and constraints is still at a stage where central agencies appear to insist on their prerogatives to the point of becoming counterproductive. Furthermore, while some additional centralization was presumably necessary in the pursuit of stabilization and adjustment policies, the
need for continuing centralization well after the economic crisis has become debatable. The issue then is to determine the type of controls that would foster a more cooperative working environment.

This discussion illustrates the continuing need for a regular review of the strategic, institutional, and systemic approaches to expenditure controls. Indeed, their effective contribution depends on updating their capability and on eliminating weaknesses.
In considering the many aspects of budgeting and expenditure control, what relevance does a topic entitled "Government Accounting: Promise and Performance" have? Doesn't budgeting relate to future priorities and total outlays? Yes, it does. Don't budgeting and expenditure control concern themselves principally with the impact of total spending on the economy, how public funds are to be raised, and decisions on the projected deficit or surplus in the treasury? Again, the answer is in the affirmative.

Why then is the subject of accounting systems on our agenda? Do financial statements for the public sector have the same relevance as they have for the private sector, important to measure profits and losses, stockholder equity, and financial conditions? The answer is yes and no. There are important similarities and important differences. My remarks will attempt to examine why good accounting provides essential information needed for expenditure control.

Budgeting and accounting have been closely linked in the United States. The Budget and Accounting Act of 1921 and the Budget and Accounting Procedures Act of 1950 established the basic framework for fiscal control in the Federal Government and continue today to recognize this close linkage. In Section 106 of the 1921 Act, the head of each executive agency is required to take whatever action may be necessary to achieve, insofar as possible, (1) consistency in accounting and budget classifications, (2) synchronization between accounting and budget classifications and organizational structure, and (3) support of the budget justifications by information on performance and program costs by organizational unit.

Responsibility for prescribing "appropriation and fund accounting in the several departments and agencies" was placed in the Comptroller General of the United States. He is head of the U.S. General Accounting Office, an agency located in the legislative branch. The
maintenance of these systems and the preparation of financial reports, however, were made a responsibility of the executive branch. Thus, the Congress wanted to preserve authority in the legislative branch for determining the extent to which accounting and related financial reporting fulfill the purposes specified, financial transactions have been consummated in accordance with laws, regulations or other legal requirements, and adequate internal financial control over operations is exercised.

Pursuant to requirements of the Comptroller General, each agency must establish and maintain systems of reliable accounting results to serve as the basis for preparation and support of the agency’s budget requests, for controlling the execution of the budget, and for providing financial information required by the Bureau of the Budget, responsible for assisting the President in preparing and executing the Federal budget. These systems are required to be maintained on an accrual basis to show the resources, liabilities, and costs of operations of such agency with a view to facilitating the preparation of cost-based budgets to be used by all departments and agencies in the preparation of their budgets.

I will return to the subject of accrual accounting and cost-based budgets later, but one should note at this point that this provision has not been fully implemented after nearly seventy years of debate and nonacceptance of this requirement in executive preparation or congressional consideration of appropriation requests.

In some respects, accounting is retrospective and historical. It tells us where we have been and is designed to give the budget preparer an up-to-date and accurate picture of financial performance. It provides accountability for funds previously appropriated and a point of departure for future budgets. It lends credence to the old adage: "You don’t know where you are going if you don’t know where you have been."

This same division of responsibility prevails in the 50 states, although responsibility for standards at the local level vary considerably, depending on provisions of state laws and constitutions. A major challenge, therefore, has been agreement on common standards and objectives. This responsibility currently is placed in the Governmental Accounting Standards Board (GASB), which began operating in 1984. This five-member board serves under a common board of trustees with the Financial Accounting Standards Board, which has a similar responsibility for the private sector.

The GASB strongly embraces the concept of accrual accounting, or, in its words, the "flow of financial resources." Among other objectives, accounting should show whether revenues were raised in an amount sufficient to pay for the services provided in the fiscal period
and demonstrate adherence to budgetary authorizations and limitations. An important objective of accrual accounting is that current-year citizens should not be able to shift the burden of paying for current-year services to future-year taxpayers. In other words, the principle is one of interperiod or intergenerational equity. On a larger scale, the large deficits and the increasing federal debt in the United States pose an issue of intergenerational equity of major proportions—an issue of nothing less than national ethics and morality.

The GASB, in its statement "Objectives of Financial Reporting," places major emphasis on accountability and interperiod equity:

Accountability is the cornerstone of all financial reporting in government. Accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used . . . applying the broad concept of public accountability to financial reporting by state and local governments creates the potential to extend reporting beyond current practice.

If being accountable means being obliged to explain one's actions, what are the limits of disclosure? How does one balance the cost of providing information against the value of the public's "right to know"?

With this question as a point of departure, I turn now to other important questions or issues.

First, are the traditional financial statements adequate to meet the needs of those responsible for expenditure control? In the United States, the President's budget contains much historical and factual information and trend analyses. It summarizes current and proposed outlays for such programs as education, health, research and development, and trust funds. All of this is valuable; some say it is essential. But is it enough? I think not.

Our Treasury Department, in cooperation with the General Accounting Office and the Office of Management and Budget, has for several years developed a prototype "Consolidated Financial Statements of the United States Government," which includes much information beyond the balance sheet and operating statement. It includes, for example, a statement of loans receivable from the public, net borrowing and from what sources, commitments and contingencies, tax benefits and subsidies, and other relevant information for the public and the Congress.

In the private sector there is evidence of the value of similar information. It is becoming increasingly evident that the traditional financial statements are not adequate to provide investors and other users with the information on which they need to base important decisions. At least one major public accounting firm is well advanced in prepar-
ing a set of financial statements—an "information model"—to meet this need.

Second, how can accounting provide data needed to improve the evaluation of the performance of governmental programs? Much progress has been made but more needs to be done.

The statement of "Government Auditing Standards" by the U.S. General Accounting Office (originally issued in 1972) has provided a stimulus for increased emphasis on performance audits embracing audits for economy, efficiency, and compliance with laws and regulations. "Value-for-money" audits in Canada and the United Kingdom have similar objectives. Our Congress has mandated audits with this objective in numerous statutes.

State and local governments have felt a similar need to seek information and analyses beyond traditional financial reports. The Governmental Accounting Standards Board has a current project to determine the feasibility of measuring government services to encourage state and local governments to develop indicators of performance in their financial reports. Twelve areas such as public health, economic development, education, fire and police protection, and sanitation are included.

Accounting data can help, for example, in measuring performance by comparing the costs per ton of collecting garbage and other wastes or the cleaning of streets or maintaining highways between one jurisdiction and another. It can also tell us whether these costs are increasing or decreasing from one budget period to another. Again, accrual accounting is essential for measuring these costs.

Can measures to evaluate performance be improved, and what can the accounting profession do to advance what I believe is now recognized as an important aspect of expenditure control?

Third, and closely related, is whether the use of accounting data can help in deciding whether to perform services and activities directly, using government employees, or contracting for them with nongovernmental organizations.

In the United States, "contracting out" has been widely used. For example, approximately 60 percent of our defense budget is devoted to contracts for goods and services. In many of these instances—particularly such activities as repair and maintenance, computer design and operations, research and development, and similar activities—budget decisions are based on comparative costs. These cost comparisons are frequently difficult and highly controversial. Without good cost data, these decisions can be subjective, or thought to be subjective, and subject to charges of political influence.

Fourth, how do we measure and disclose the commitments made for post-employment benefits? Benefits such as retirement, health
care, and life insurance have become increasingly popular for employees in a society where people live longer; for employers, they are attractive in that they reduce current outlays, deferring them to the future. From the standpoint of expenditure control, the danger is that these costs become “hidden costs” that become all too real in future years.

The role of the accountant is to devise reasonable ways to measure these commitments and disclose them for those authorizing these benefits. This task is not easy, given the uncertainty of the cost of providing these benefits, changing needs of retirees, employee turnover, and differing contractual arrangements. Some of these plans are funded in advance; relatively few are adequately funded. Some share the costs with current employees; others are financed entirely by the employer. These accumulated costs are huge and growing. The accountant and the budget analyst need to find ways both to measure and to control these costs and to establish policies for funding and sharing them with employees.

Fifth, an area of great importance involves measuring the condition, age, and serviceability of infrastructure and other major physical assets. Infrastructure—streets, highways, water supply, fire protection equipment, etc.—is both expensive and essential to society. But how do we measure its current condition?

Like post-employment benefits, there is a tendency to postpone repairs, maintenance, and replacement—deferring these costs to the future. Here again the accountant can contribute to expenditure control by providing improved ways of measuring the condition of these assets, factoring in past experience, the benefits of life-cycle costing, the extent of repairs and maintenance in relation to need, and cost-benefit analyses of replacement versus maintenance.

Accounting data are needed to record how much has been spent for repair and maintenance. They are needed to disclose actual expenditures in comparison with estimated needs, and how much has been appropriated in comparison with budget requests. They are needed to help in deciding whether it is less costly to replace equipment and infrastructure or to continue to spend funds for maintenance and repair.

Physical assets are not only important in carrying on government activities and programs but are often essential for a strong private enterprise system. Decisions on acquisition, maintenance, repair, and rehabilitation need to be made in the light of the best information available. Without this information the risk is that we spend too much or too little.

Finally, and I do not need to elaborate at great length, can accounting data help in comparing budgeted with actual expenditure?
Financial reporting should show whether financial resources are obtained and spent in accordance with the adopted budget. The budget is the single most important expression of the policies, program, and plans to execute programs by a governmental entity. It is both a means of control by the legislature and the executive as well as their accountability to the taxpayer. Did government overspend or underspend budgeted amounts? Either can be a matter of concern. Conditions do change, but the reasons for change need to be fully documented; only in this way can budgets be made more accurate for the future.

It would not be difficult to enlarge on those issues where good accounting can play an important role in expenditure. For example, I have not mentioned the measurement of performance of public enterprises, obviously important in their impact on public sector budgets. Nor have I pointed out the value of accounting information in estimating revenues and expenditures for future budget periods. These areas are of importance in longer-term expenditure control.

Much progress has been made over the years in developing useful accounting systems that, in combination with modern computer technology and information systems, have made accounting systems and financial reports increasingly useful in expenditure control. In a democratic society, expenditure control will always be a part of the political process—the control over new programs, the level of existing programs, and the evaluation of the effectiveness with which legislative mandates are carried out.

The role of the accountant in government is different in many ways from the role of the accountant in the private sector. There, as pointed out previously, he plays an important part in measuring profits and losses, stockholder equity, and financial conditions. In government, the budget is the primary instrument through which political control is exercised. The legislative process itself provides a means of disclosure not present in the private sector. The accountant, in other words, can make his greatest contribution by focusing on areas that provide information needed for expenditure control—and the preparation and execution of the budget. In doing so, he has an obligation to demonstrate that the accounting system developed will help the decision maker in this important task. Focusing on such areas as I have outlined above would, I believe, help in this regard.

It should always be kept in mind that accountants, in devising accounting systems, are not decision makers on matters of expenditure control. They can play an important part, however, in developing credible and consistent information that can be relied upon by decision makers. In short, they are information suppliers, not only to the immediate decision maker but to the general public,
that ultimately influence the decisions with respect to expenditure control.

In the political arena in which expenditure control decisions are made, experience indicates that the executive and the legislator will be governed by their desire to control obligational authority or financial commitments for new and existing programs, thus taking precedence over cost-based budgeting based on accrual accounting. Experience also indicates that the focus will be on cash outlays and revenues because these will be the measure of the need for new revenues or borrowing. In this setting, accrual accounting can play an important role in disclosing the financial condition of a governmental entity but will only be indirectly related to expenditure control. In the final analysis, how much time and money should be spent in improving accounting systems must be subject to the same cost-benefit analysis that is applied to program decisions.
Cash Management

HEMA R. DE ZOYSA

Cash management by a treasury conjures up images of high-powered officials wheeling and dealing in money and securities markets using the most sophisticated electronic equipment and being in full control of the timing and composition of borrowed funds, the disposal of surplus funds, and the efficient exercise of internal mechanisms for the inflow and outflow of funds. Yet, given the large flow of funds through the central government (usually between 25-30 percent of GDP in any one year), the process of conserving cash, optimizing the flow of cash, and generally raising the awareness of cash costs, collectively referred to as “cash management,” is an often neglected area of public financial management. The primary interests of most officials in the budget execution process are issues of raising finance or disbursing funds; the opportunity cost of money is not sufficiently taken into account in the collection of government funds and in disbursement practices.

A number of reasons explain this lack of concern for cash management. First, government departments or spending agencies experience no cost for managing their cash resources poorly or benefit for managing them well. Because of how government is organized and accounts are kept, the system fails to hold accountable those responsible for incurring the expense of interest; departments’ cash management responsibilities are limited to depositing public funds and submitting requests for payment. As a consequence, managers are not aware that the cost of borrowing money is a significant element in the cost of their programs or activities. Thus, costs arising from poor cash management (in the form of increased interest charges) are shown as a general budgetary charge as interest on public debt. Second, the main focus of the budget execution process is on the release of funds to spending agencies, and on the obligation of funds by these agencies; the actual spending of money is often not well coordinated with the apportionments of the budgetary appropriation. Third, the primary focus of government accounting systems is the accountability of
funds (propriety) and not the efficiency with which funds are utilized. What follows is a discussion of why cash management is significant in public financial management; the practices and procedures that may hinder the government in managing its cash resources effectively; and some of the requirements of an effective cash management system.

ASPECTS OF A CASH MANAGEMENT SYSTEM

The purposes of cash management are twofold. The first is to ensure that a borrower stays well within the limits of credit that policymakers have determined or lenders are prepared to extend. From the borrower's point of view, the second purpose of cash management is to ensure the payment of as little interest as possible, or from the lender's point of view, to ensure that he earns the maximum possible on money lent. The importance of cash management was not fully recognized even by the private sector until the late 1960s, when interest rates reached high levels. Corporations and financial institutions developed systems of varying degrees of sophistication to ensure that cash did not lie idle, and that it was quickly used either to pay off obligations incurring interest charges or to generate additional cash by investing in revenue-yielding paper. These policies were supplemented by improved procedures that supported a desire to make cash management more efficient. Thus (1) the movement of cash between creditor and debtor was accelerated by electronic means; (2) banking operations were consolidated to minimize the use of idle funds; (3) payments were consolidated to reduce the cost of transactions; and (4) finance managers and treasurers were appointed to provide expert advice on the borrowing and investment of funds.

Cash management is of importance in the context of Fund stabilization programs. One of the significant aspects, and often a performance criterion, of programs supported by the use of Fund resources, is credit to the central government by the banking system. Significant variations to broaden the scope of this condition may include activities of the central bank, and/or credit made available to selected nonfinancial public enterprises by the banking system. Such performance criteria would imply adherence to target levels, usually at the end of each quarter. Measurement of quarterly performance would, in turn, imply knowledge of the level and adequacy of net credit, that is, borrowings less government deposits held by the banking system. Since deposits are a function both of checks issued and of checks deposited, the measurement of the latter can be critically affected by the time and the quantity (value) of government checks that can remain in circulation before being presented to a bank and thus being
measured as credit to government. The variation of this “check float” can in certain circumstances be significant and affect the net credit position of government. This implies that in certain situations the mere withholding of allotments or checks issued may not in itself be sufficient to meet performance targets, if the “float” itself contracts significantly. Such variations in outflows can, to an extent, be balanced by advancing the flow of funds to the government. Thus, to meet likely critical overshooting of target levels, the government may choose either voluntarily or by discretionary action to advance taxes, license fees, or other unrequited payments, and thereby meet the performance targets. Management of fiscal performance targets necessitates close, careful, and active involvement of the core financial agencies in cash management matters.

Cash management is also significant for general economic policy in the wider context of a public sector borrowing requirement. If at a time when fiscal and monetary authorities are attempting to keep a tight hold on credit expansion by traditional methods, cash management procedures and practices permit public agencies to build up cash balances in the banking system (that is, lend to commercial banks), such actions can be in conflict with the aims of fiscal and monetary policy. One such situation is where the central government has large cash deficits that it has to finance in an expansionary manner (by borrowing from the banking system), while the rest of the public sector has large surpluses. If these surpluses are held in commercial banks, they could cause additional credit to the private sector, thereby exacerbating the expansionary potential. The situation may become even more distorted if a part of the deficit of the central government or the surplus in the rest of the public sector are due to transfers from the budget to public enterprises. Poor purchasing procedures, unwarranted increases in stocks, or liberal credit policies by public enterprises are actions that could also exert undue pressure on credit expansion in the public sector. An effective cash management system within the public sector would help to resolve some of these issues.

The flow of budgetary receipts and payments has a seasonality that is unique to each country. Thus revenue flows from sources such as income tax or customs duty payments, or the use of funds for social service or transfer payments, or a rush of expenditure at the end of the year as agencies try to utilize their appropriations result in a pattern in the flow of funds that varies from country to country. Such macroeconomic cash management—which is based on a knowledge of the overall budget surplus or deficit and on debt maturity dates—clearly involves forecasts of monthly receipts and expenditures and plans for the placement or withdrawal of short-term, medium-term,
and long-term debt in money and capital markets. In addition to these variations, on any one day, the government may be short of cash to meet its expenditures. Conversely, it may have more cash on one day than it needs, and the problem here is to utilize the surplus appropriately on that day. There is thus a need to monitor, at a micro level, the daily and weekly flows of receipts and disbursements that could reduce idle funds and excess borrowing to a minimum. The concern of cash management at both the macroeconomic and the microeconomic levels is to meet the cash requirements of the government at a minimum cost, including the opportunity cost associated with uninvested funds. Thus interest costs or interest benefits are incurred or accrue to government through (1) borrowings to finance expenditure in excess of cash receipts (financing budget deficits or investing budget surpluses); (2) borrowings to maintain liquidity when receipts do not coincide with expenditure requirements (seasonal financing); and (3) borrowings to ensure liquidity when there are uncertain receipt and expenditure patterns (maintaining minimum liquid reserves).

PROCEDURES AND PRACTICES IMPAIRING CASH MANAGEMENT

For each day that government receipts are delayed in collection and are not held in the form and in the location where they may be spent or invested, the government incurs an interest cost. Thus cash management will be seriously hampered if no central authority or agency is entrusted with the responsibility of managing the cash resources of government. Cash management could also be impaired by the multiplicity of special funds. While the existence of special funds is often determined by law, the number of deposit accounts should be kept to a minimum, with each fund separately identified in a general control account. Thus if control accounts are accurate and timely, actual cash and deposit accounts could be aggregated for cash management purposes.

The use of private banking facilities by public sector agencies could also complicate cash management. One of the principal benefits accruing to banks is the interest they earn on balances left with them by a government agency. The costs and time of transfers are increased when there are unforeseen or deliberate delays in transmitting and crediting revenue receipts to a central or consolidated fund. Delays in payment, transmission, and notification of government obligations are of considerable advantage both to the debtor and to the banking system and in effect constitute credit to these agencies. In general, the maintenance of a bank balance in excess of liquidity needs should be
avoided, as it might lead to increased borrowing by the government at rates of interest higher than the bank may allow on the balances of a public agency.

While the reduced collection float, that is, an acceleration of the receipt and processing of cash payments mentioned above, is essential for improved cash management, it does not follow that there should be an increase in the disbursement float, which is the lag between the time a check is prepared and the time it is presented for payment. Increases in the disbursement float will almost always increase the time taken for suppliers of goods and services to obtain payment, which in turn would result in the supplier increasing the cost of his supplies by the opportunity cost of the payment due before reimbursement is received. In this situation the government should try to reduce the costs of services provided, by instituting better transfer procedures (including electronic fund transfers), aggregating multiple but small payments, decentralizing payment agencies, and using bank accounts. At the same time a thorough review of ordering, supplying, and payments procedures may be warranted. These procedures would include advance payments (partial or total) of goods bought (including purchases abroad) and delivery time and time involved in the final consumption (use of stocks) of these goods.

ELEMENTS OF AN EFFECTIVE CASH MANAGEMENT SYSTEM

Four essential elements would make a cash system more effective.

Cash Flow Forecasts

The total of receipts and expenditures outlined in the government budget is an indication of the government’s overall borrowing requirements for the fiscal year. However, these aggregative figures do not reveal the seasonality of either receipts or expenditures that occur during the fiscal year and that are a critical factor in the government’s ongoing cash and debt management operations. One of the most serious weaknesses in existing cash management is the absence of planning and the inadequate procedures for cash flow reporting. What is required is not only a monthly, but also a weekly and daily forecast of receipts, disbursements, and the resulting cash balances within the government financial system, including all funds that the government could use on a temporary basis. Such forecasting should,

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1Based in part on Rasheed O. Khalid, “Budget Execution and Cash Management” (unpublished; Fiscal Affairs Department, International Monetary Fund, 1982).
of course, be continuously reviewed against actual plans, and the causes of variations fully analyzed, so that forecasting techniques and practices do not become unsatisfactory for determining cash needs. A review of the institutional arrangements (centralizing the responsibility for preparing such forecasts, continuous consulting with the monetary authorities, and regular review procedures) should also be undertaken.

**Cash Inflow Control**

From the point of view of cash management, the purpose of cash inflow control is to minimize the time between when money is due to be received and the time when money is available for spending or investment. Accelerating the flow of receipts is useful therefore only if payments are promptly processed and deposited in the appropriate bank account, and arrangements are made, in turn, for the prompt transfer of credit balances in commercial banks for use by the government. All revenue departments should have a collection plan that is part of the cash flow forecast. The causes of significant variations from planned collections should be evaluated and adjusted where necessary. In times of credit stringency or rising inflation the tendency would be to delay payments, increase appeals to avoid payment, or slow the payment process. In such situations, the cost and kind of penalties both for payers and financial intermediaries should be carefully reviewed and strictly enforced.

**Cash Outflow Control**

As with inflows, outflow control begins with the terms of payment and continues to the time that the funds are charged to the payee's account. A weakness in outflow management is to ignore the disbursement float and to treat funds as no longer available on the day the check is written. Unless the reasons are compelling, payments should be made only when due. As mentioned earlier, both late and premature payments should be avoided. Procedures should be established for regular comparison of actual with planned disbursements.

**Determination of Cash Balances**

Operating cash balances should be kept to a minimum. As a part of this aspect of cash management, it has sometimes been suggested that procedures should be introduced for charging interest to individual agencies for funds used or for crediting them for funds not used. The existing arrangements between financial intermediaries and the government and nonfinancial public enterprises should also be re-
viewed. If value for money is to become a working principle in government, a significant start should be made by establishing a businesslike arrangement between the government and the banking system. The principle that the government (including other public sector agencies) should earn interest on all its deposits and that it should, in turn, pay for all the banking services it receives should be seriously explored.

The preceding four elements are the requirements for a central authority responsible for arranging the government’s borrowing, for prompt and efficient investment of temporary balances, and for controlling rather than simply monitoring the flow of spending. In addition to such overall cash management requirements are the cash management concerns of individual programs, with the need to monitor spending compared with the budget, to stay within the available budget, to coordinate spending with apportionments made at a higher (central government or departmental) level, and to obtain best value for money. Countries vary in the extent to which the central financial agency delegates authority to spending departments to take their own decisions once annual appropriations have been enacted by the legislature, and in how actively they monitor departmental management. In an increasing number of countries the trend is toward devolving more responsibility from the center to the spending agencies; the quid pro quo is a strict cash limit on these appropriations backed up by reliable and up-to-date information on actual spending.
Measuring Efficiency in Government: Techniques and Experience

JACK DIAMOND

BUDGETING FOR PERFORMANCE

Traditional views of the budget and budgeting procedures have undergone some recent changes. The previous view of the budget was as an exercise primarily in resource allocation and input control, which was usually highly centralized. This approach to the budget accepted a set of policy objectives—often poorly articulated and usually unquantified—and allocated inputs to reach those objectives. At the same time, central budgeting agencies focused almost exclusively on control and compliance as the primary modus operandi in financial management. There was often little follow-up in examining the subsequent performance of spending departments. The new trend, indicated here as “performance budgeting,” but with different titles in different countries, aims to forge a more direct link between the allocation of resources through the budget and performance in reaching objectives. This reorientation has necessitated a number of changes in traditional budgeting. Most noticeably, there has been a greater emphasis on measures of performance. Indeed, the basis of recent efforts to improve the management of government services has focused on developing measures of output and on assessing productivity in government.

1In Australia, the Financial Management Improvement Program (FMIP); in Canada, the Increased Ministerial Authority and Accountability Reforms (IMAA); in the United Kingdom, the Financial Management Initiatives (FMI); and in the United States, the Productivity Improvement Program (PIP). For a fuller discussion of country experiences, including those of Denmark and Sweden, see Organization for Economic Cooperation and Development (1988).
A number of reasons can be advanced for this change in focus. First, central budgetary agencies had a major incentive to concern themselves with productivity in the face of "fiscal stress" that they were experiencing. As operations and maintenance expenditures were squeezed, governments became concerned that this squeeze was resulting in reduced levels of service rather than gains in productivity. To check that the financial restraint was indeed resulting in greater efficiency necessitated renewed attempts to measure productivity. Second, in an environment of budgetary cuts there was heightened concern about the relative price effect (or Baumol’s disease), and the view was widespread that government services could not match the productivity gains of the private sector, with a consequent increase in the relative size of government. Third, institutionally, measuring productivity was found to be less controversial than trying to measure the effectiveness of programs in attaining their ultimate objectives. The former approach did not question whether present activities were actually effective in reaching the desired goals. Moreover, it focused entirely on those aspects that were most under the control of the resource managers, whereas performance and effectiveness could be more sensitive to exogenous factors.

The new emphasis on performance indicators had its genesis in previous attempts at improving budgeting. At first, the focus was on the management of inputs, where economizing was the prime concern. This approach was followed by attempts to manage outputs, with spending departments concentrating on workloads. Most recently, there have been more sophisticated attempts to relate inputs to outputs, with improved efficiency as the primary goal. The current renewed emphasis on performance signals an attempt to go one stage further and to assess the effectiveness of outputs in reaching objectives. While the latter stage is still in its infancy, over the last decade there have been numerous attempts aimed at improving efficiency in providing government services. It is hoped that in reviewing this practical experience much can be learned about the obstacles likely to be encountered in developing indicators of performance and analyzing the effectiveness of resource allocations.

3See Baumol (1967), where it is demonstrated that if labor productivity is assumed constant in the government sector and that of the private sector rises exponentially, then if government goods and services in real terms are to remain as fixed proportions of total goods and services, government expenditures as a proportion of total expenditure must rise.
MEANING OF EFFICIENCY

Economists generally distinguish two distinct concepts. First, there is technical efficiency, which is met when the maximum possible output is produced with a given supply of resources. It should not be possible to reduce any input without reducing the volume of the output. Technical inefficiency in terms of not being able to attain this level of resource use for a given output is symptomatic of more general shortcomings in internal organization of the producing unit (whether owing to political interference, bureaucratic procedures, wage and personnel rigidities, etc.). This type of inefficiency has been labeled X-inefficiency by Leibenstein, who argues that it is likely to be the greatest source of inefficiency, particularly in the public sector. Second, there is the concept of allocative efficiency, which moves from physical quantity measures to the costs of inputs. Allocative efficiency is met when the cost of any given output is minimized by combining inputs in such a way that one input cannot be substituted for another without raising costs.

Using this theoretical framework, and following the methodology of Farrell (1957), it is possible to devise measures of relative efficiency. If an agency is on its technical output frontier, such that with given inputs it could not be expected to produce more output, its efficiency score would be 100 percent. Shortfalls from this technically efficient output level would result in correspondingly lower scores. In comparisons of relative efficiency, it is essential to distinguish output from input efficiency. As described above, efficiency has two dimensions: the management unit can minimize inputs to reach a given output, or maximize its output with given inputs. Output efficiency is therefore the ratio of the unit's actual output to expected output, given its inputs. Input efficiency, on the other hand, is defined in terms of the ratio of its expected inputs to its actual input, given its output. Only under very restrictive assumptions will the efficiency score of a management unit in terms of its input efficiency match its score in terms of output efficiency.

Only under stringent perfect market conditions with multiple suppliers and demanders of goods and services is it possible to maximize efficiency. In practice it is difficult to ascertain whether allocative efficiency is being attained in the public sector. Rather, in most cases in the public sector, performance can only be measured in technical terms relative to other agencies offering similar services. However, with no "ideal" or "standard" performance in the production of

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4See Leibenstein (1966).
5A demonstration is contained in Levitt and Joyce (1987), pp. 95ff.

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government services, and where competitive conditions obviously do not exist, the most that can be achieved is to develop management and information systems that mirror as closely as possible conditions that will maximize efficiency. It has been found that to do so causes great demand for certain types of information:

- quantify intended outputs and associated costs;
- quantify change in output associated with costs;
- ascertain whether output maximization or input minimization is the governing objective;
- discover the scope for improving technical efficiency;
- assess with a given output whether inputs can be substituted for one another to reduce total costs;
- quantify the extent to which efficiency can be improved by bringing worst performers closer to the average.

In answering such questions, the measurement problems faced and the difficulties encountered in applying quantitative techniques have come to be recognized as a critical factor in adopting a performance-based approach to budgeting.

**MEASURING PERFORMANCE IN TERMS OF EFFICIENCY**

Conceptually, the term "efficiency" appears clear cut and precise. An efficient allocation of resources is one where the greatest possible output is obtained from available resources (or where a given output cannot be produced with less input). In practice, there is real ambiguity about the output of government services and, as a consequence, the linkage between resource allocation and performance is far from direct and explicit.

Producing government services does not conform to the simple technical production function relationship linking inputs to outputs, described in the previous section. Rather, government outputs are often social consequences that are difficult to define precisely and tend to be multidimensional and interrelated. At the same time external social influences are also at work, masking the impact of government activity. As a result the output of any government good or service must often be measured along a number of dimensions by often imperfect, incomplete, multiple proxy indicators. It is perhaps with these considerations in mind that national accountants typically measure real government output by reference to input prices and volumes and avoid output measures. However, it is far from satisfactory. There is no reason in principle why input and output values should change in proportion, and conversely, there is no reason to
assume zero-productivity gains and the existence of constant returns to scale in government.

One can characterize the production of a public service as resulting from a process that first begins with the purchase of inputs (labor, capital, etc.) to support certain activities (patients treated, benefits paid, children taught, etc.) that have certain social consequences that are the final output of the process (relief of poverty, better health, improved knowledge, etc.). While the measurement of inputs is the most straightforward and is usually reflected in costs, the final output is much more problematic. Often, without precisely definable impacts, analysts have settled for intermediate measures of output that describe the activities of government agencies (benefits paid per employee, patients treated per doctor, children taught per teacher, etc.). However, insofar as these intermediate outputs could be viewed as the inputs to reaching the government’s final objectives, the simple discussion of the meaning of efficiency above needs further elaboration.

To a large extent, translating efficiency into operational terms has floundered on this conceptual distinction between outputs and inputs. The confusion is encountered throughout the public service literature. For example, take the case of crime prevention, where certain inputs (men and equipment) are combined in certain activities (patrol units) to produce an output (crime prevention). In some cases, as in Bradford, Malt, and Oates (1969), police patrols are cited as "outputs." Craig (1987), in analyzing police distribution, in his terminology called the number of police patrols an input toward a final output, crime prevention. Thus the "clearance rate," the percentage of crimes that are considered solved, usually by arrests, is not the final product—which is public safety—but is merely a stage along the way. For him, the clearance rate is an "intermediate" output (p. 335). The amount of "output" (final output to consumers), that is, public safety, is measured by subtracting the crime rate per capita from a constant term, this term being "slightly larger than the maximum crime rate" (p. 335). To add to the confusion, what Craig terms "output" is referred to as "outcome" in Behrman and Craig (1987, pp. 42-43). In other areas what the latter term "outcome" is called "impact."

This distinction between outputs and outcomes (or impacts) has important implications for the concept of efficiency. Efficiency is usually defined as an optimal input-output relation that takes into account all factors of production used in outputs. Obviously, it is of critical importance how output is defined. If, as was implied above, output is defined as intermediate output, there is no problem. But if the focus of interest is in the ultimate attainment of policy objectives, perhaps another term should be used, such as "effectiveness," which has been suggested (Burkhead and Ross, 1974), and which is now
used extensively. Thus in public expenditure management it has been useful to distinguish three concepts: economy refers to the actual use of resources in relation to planned levels; efficiency refers to the use of resources in relation to outputs; and effectiveness refers to the impact on and fulfillment of program objectives.6

Measures of effectiveness or "performance indicators" are at an early stage of development. Part of the problem lies in developing practically applicable indicators of the degree to which policy objectives have been attained. In much of the public sector, objectives have been defined in generally vague and noneconomic terms, and it is partly for this reason that most empirical work has focused on inputs and processes and has little to say about outputs and objectives. Although some work has been done by evaluators in defining desirable properties of performance indicators,7 it has been overcome by a number of complications. First, there is the problem of the time span of the ultimate impact of policies. For many social programs the outcome can only be expected after a long time lag, whereas for the evaluator it is easier to deal with changes that manifest themselves quickly. It should be admitted that often the best an evaluator can do, given the usual constraints and lack of knowledge, is to find out how well any short-run goals have been met. Second, there is the problem of unintended outcomes, which arise for many reasons. For example, the program may be poorly conceived. A loan program to inefficient small businessmen may only lead them deeper into debt. Or, owing to social interaction, contagion effects appear. People who have never attended a health education program learn the new ideas of behavior through contact with participants. Third, the evaluator must take care to distinguish a program's impact from those of other forces working in a situation. Exogenous factors include both systematic and random influences outside the control of the executing agency. Examples of the former include the diagnosis of patients admitted to hospital (the hospital's case-mix), the social background of pupils in a school, and the unit costs of inputs used by the organization. We will return to the third problem and the ways of allowing for external factors when we review quantitative techniques used to measure efficiency, and particularly relative efficiency of different units providing the same service.

Efficiency measures or indicators have usually concentrated on estimating ratios of outputs to inputs, which allow managers comparisons with the ratio achieved in earlier years, with the planned ratio,

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6See discussion on the meaning of efficiency in International Monetary Fund, 1988, pp. 26ff.
7For a discussion of the progress made in developing social indicators, see Eilon (1984) and De Neufville (1975).
with the ratio of others delivering the same service, and perhaps with
the ratio that might be achieved by alternative policies. Ideally, these
ratios can relate both to ultimate and to intermediate objectives. A
common measure of efficiency is the unit cost of delivering a service:
the cost of creating a new job, paying a pension, or building a mile of
road (although, strictly speaking, unit cost is an inverse ratio of
efficiency—cost divided by output rather than the other way round).
Unfortunately, such comparisons are complicated by the multiple ob­
jectives and outputs generally pursued by public sector providers.
Nor is the use of several ratios particularly useful for the comparison
of effectiveness, because some organizations are better than average
according to certain indicators and poorer than average according to
others. There is thus no clear means of deciding which organization
is the more efficient, because no one unit is dominant, that is, superior
in all measures. In addition, ratio analyses cannot capture the effect of
factors that affect the performance of the organization but are not
under the control of management (for example, demographic charac­
teristics, weather, and general economic conditions). Further, a multi­
service environment gives rise to the problem of trade-offs. That is,
success in one ratio can only be achieved at the expense of perfor­
mance in some other ratio. Without weights to indicate the relative
importance of different ratios it is difficult to be definitive on relative
efficiency.

These problems in employing simple ratios to compare the relative
efficiency of different units in a multiproduct environment have led to
the adoption of more sophisticated techniques. The next section ex­
amines critically two of the techniques most used. This section is
followed by one that illustrates some attempts to employ these tech­
niques to improve the management and performance in three broad
categories of government services.

A REVIEW OF QUANTITATIVE TECHNIQUES

From the above discussion it is clear that efficiency is essentially an
empirical problem and is thus amenable to quantitative analytical
techniques. Although some overlap occurs, the techniques have gen­
erally fallen into two distinct categories: statistical and nonstatistical.

Regression Analysis

Of the statistical techniques, regression analysis has enjoyed the
widest application. It seems particularly suited to relating output to a

*See Eilon (1984), for a discussion on choosing ratios.
*See, for example, Lewin, Morey, and Cook (1982).
set of inputs, as it explains the variation in one data series in terms of variation in one or more other series. In this way a production function of the following form can be specified

\[ Q = a + bR + u \]

where \( Q \) is the variable to be explained, and the values of \( a \) and \( b \) (the regression coefficients) are chosen to minimize the variation in \( u \), the unexplained variation in \( Q \). This method generalizes to more than one resource, that is, more than one explanatory variable (multiple regression), and to nonlinear relationships. To use the method, however, involves tackling a number of problems at three distinct levels.

**Specification of the Model**

As indicated above, efficiency can be defined in terms of minimizing costs for a given output, or its dual, maximizing output with given costs. In terms of the regression model an important prior question must be answered: (a) are differences in output the result of differences in resource provision; or (b) are resources allocated as a result of a policy toward output. In the first case, the regression model should be specified

\[ Q = a + bR + u, \]

and the implicit behavioral model implies the spending agency is trying to maximize its output with given resources; and in the second case the model is specified

\[ R = a + bQ + v, \]

and the behavioral model implies the agency is trying to minimize the cost of its output. A third hybrid model is one of interaction: resources are provided to improve output, but output reflects resource provision in a simultaneous system, that is, \( Q \) and \( R \) feed back onto one another (see example in the next section).

Choice of specification is not academic, since fitting different models to the same data set can give quite different results in the most likely case of imperfect correlation between \( Q \) and \( R \).

**Estimation Problems**

In specifying the production function, it is quite likely that output will differ between agencies or regions or between different time periods, not simply because of differences in \( R \) but owing to other socioeconomic variables. The production of government services takes place in an open system, and a large number of social influences might affect the extent to which resources and outputs are related.
This problem has two aspects: (a) identifying these important conditioning factors; and (b) once they have been identified, allowing for their influence.

A weakness of the regression technique in calculating coefficients $a$ and $b$ is that it must make the very strong assumption that the error term $u$ is distributed in a purely random way. Exclusion of an important explanatory variable breaks this assumption and causes $a$ and $b$ to be misspecified. Unfortunately, in the absence of perfect knowledge, one cannot always be certain that all important explanatory variables have been included in the regression equation. Even if one is fairly sure that all conditioning factors have been included as explanatory variables, other problems must be overcome. It is possible to test for the influence of other determinants of output by including them in a multiple regression equation of the form:

$$Q = a + bR + cA + dB \ldots xZ + u,$$

where variables $A \ldots Z$ are other determinants of output. However, two problems are typically encountered in this approach. First, it is difficult to isolate the influence of each variable individually because they are often correlated with one another. As a result, those that matter in reality might not appear statistically significant. This is the so-called multicollinearity problem. Second, the number of potential explanatory variables may be so large that they begin to dwarf the size of the sample and lead to unreliable estimates of the coefficients. This is called the degrees-of-freedom problem.

A number of statistical techniques have been used to circumvent these difficulties, none of which is entirely satisfactory. Multicollinearity may be detected by a number of stepwise procedures. Alternatively, another approach is to use principal components analysis, which transforms the initial large set of variables into weighted combinations of the original variables. These components, defined to be independent of each other, can be used as variables in the regression equation, thereby circumventing the multicollinearity problem. Of course, causal interpretation of the constructed components is often difficult.\(^\text{10}\)

One approach to the degrees-of-freedom problem is to use the technique of stepwise regression. This will select a smaller set out of the total set of possible determinants on the basis of those determinants that provide the best statistical fit to the data. Unfortunately this criterion may not be legitimate in the presence of multicollinearity. One less statistically sophisticated approach is simply to take the total

\(^{10}\)Discussed in Mayston and Smith (1987).
or average value of all seemingly relevant indicators and to use it as a composite summary indicator. Certain studies in the education and health fields have used this procedure. Some composite indicators assign equal weights to the individual social indicators chosen, others give them different weights according to some judgment of their relative importance.

Interpretation Problems

In comparisons of efficiency, a measure of an agency's efficiency with respect to the chosen output is then said to be the residual, \( Q_i - \bar{Q} \), the difference between actual output (\( Q \)), and the output predicted by the regression model (\( \bar{Q} \)). In this way regression analysis only allows us to compare individual performance with the mean, not with the feasible level of efficiency. If all agencies are grossly inefficient, interpreting an agency with a positive deviation from the mean as having a relatively good performance may be misleading, interpreting it as being most efficient is certainly illegitimate.

Moreover, regression analysis typically identifies the relationship between inputs and a single output. It therefore explains how one objective is being met. However, it says nothing directly about the relationship between a wide range of objectives usually vested in the public services. It must be recognized that in a multiple-output world, inverse relationships will exist: success in one dimension can only be achieved at the expense of performance in some other area (that is, as well as interdependency of inputs or multicollinearity, there is interdependency of outputs). Although, multiple regressions can be employed to estimate the effects of some inputs on different outputs, multiple outputs cannot be taken into account simultaneously.

Data Envelope Analysis

Given the need to accommodate multiple outputs and inputs, there have been attempts to derive practical measures of public sector efficiency that do not depend on common units of measurement, or on an a priori set of weights to reflect social objectives. One nonstatistical technique that has received much attention recently is data envelope analysis (DEA).

This technique, based on the early work of Farrell (1957),\(^{11}\) examines output and input relationships not from the viewpoint of average relationships of regression analysis but from the perspective of best possible performance as represented by the outlying observations. Its

\(^{11}\)For a useful survey of the technique and its development, see Barrow and Wagstaff (1989).
primary use is in measuring the relative technical efficiency of different decision-making units by comparing each unit with a comparable hypothetical unit formed as a weighted average of a number of efficient units, a reference set. Based on linear programming, DEA weights inputs and outputs so as to produce a single summary measure of the relationship between inputs and output of each decision-making unit. Weights are calculated so as to maximize the efficiency score of each unit, and an efficiency score can be derived equal to the weighted sum of outputs or the weighted sum of inputs.

However, a number of problems have been encountered in applying the DEA technique. First, the technique is entirely mathematical: it simply calculates the ratio of specified outputs to the specified inputs. It does not test for the statistical significance of the implied relationship between outputs and inputs. By assuming that the direction of causation is known, which is not always clear a priori, the results of the DEA could be completely irrelevant. Moreover, because of its nonstatistical nature, deviations from best practice efficiency arise solely from technical differences in efficiency with no allowance for stochastic deviations (for example, resulting from misspecification or measurement error).

Second, the production frontier is constructed from a subset of the data (the most efficient management units), making it vulnerable to extreme observations and to measurement error. That is, by producing a relative rather than an absolute measure of technical efficiency, the results and rankings may well alter with a change in the sample. Of course, nonhomogeneity in sampling is also a problem of regression analysis but one that has led to the development of diagnostic tools. In DEA, however, if a unit concentrates on one particular output to the exclusion of others, and is the only unit to do so, it will automatically be deemed efficient. It will form part of its own unique “facet” of the efficiency frontier, at one extreme of one axis. In this way DEA will tend to overestimate efficiency among “unusual” authorities. One suggestion has been that cluster analysis be used to produce discrete groups of more homogeneous units on which to perform a DEA.

Third, it shows each management unit in the best light possible by calculating weights for outputs and inputs that produce the highest possible efficiency score. The latter occurs because DEA gives greater weight to those inputs/outputs where the management unit concerned does relatively well. However, two rather unsatisfactory results emerge. First, by evaluating anything as technically efficient if it has the best ratio of any output to any input, one can end up with an entirely inappropriate input/output ratio. As a result a careful a priori selection of the variables is essential. Second, one well-
established property of the technique is that efficiency scores will tend to improve as the number of inputs or outputs included in the analysis increases, since there is more chance of finding a more favorable comparison with the rest of the sample. As a result care should be taken to avoid including more environmental factors than are relevant to the operation of the service being examined. It has been suggested therefore that it is important to carry out a sensitivity analysis to test how much the results are changed when one output or input is excluded from the analysis.12

Fourth, the technique restricts the functional form of the production frontier to linear subsets, which in turn implies the assumption of constant returns to scale. If the linearity assumption is known to be unrealistic, then the factors should be transformed so that the relationship between output and environmental factors becomes linear. Normally, one views the production function as convex to the origin, so that up to a point increasing inputs increases output more than proportionately. After a certain point further inputs lead to diminishing returns in terms of output. By assuming constant returns, DEA can produce extremely misleading results.

Recognizing the importance of these restrictions, a number of attempts have been made to circumvent some of the DEA's main deficiencies. Perhaps the most important is to loosen the very restrictive assumption of constant returns to scale. In a subsequent paper Farrell and Fieldhouse (1962) were able to extend this approach to nonconstant returns to scale technologies.13 The deterministic nature of best-practice production frontier has been relaxed by the introduction of a disturbance term in its specification by Aigner and Chu (1968). However, without statistical assumptions on the behavior of this disturbance term it is not possible to conduct statistical tests. Thus the Aigner and Chu model has been extended by making some statistical assumptions about the disturbance term. It has been assumed that observations on the disturbance term are independently and identically distributed and independent of the explanatory variables used. This assumption allows the production frontier to be estimated by either corrected least squares or maximum likelihood techniques.14 With the introduction of a stochastic dimension to the determination of the production frontier, it is no longer possible to attribute all variations in performance from the frontier to inefficiency. In contrast, the stochastic frontier of Aigner, Lovell, and Schmidt (1977) and

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12Demonstrated in Mayston and Smith (1987).
13See also Grosskopf (1986).
14See Richmond (1974) and Schmidt (1976).
<table>
<thead>
<tr>
<th>Technique</th>
<th>Solutions</th>
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| Regression Analysis           | 1. Efficiency measured in terms of one output at a time in a multiproduct environment.  
                                 | 2. Identification of all relevant determinants.  
                                 | 3. Causal process.  
                                 | 4. Determining variables may be highly correlated.  
                                 | 5. Determining variables may be too numerous compared with sample size, causing a degrees-of-freedom problem.  
| Data Envelope Analysis        | 1. No solution.  
                                 | 2. Using the principal components of the regression as variables in regressions.  
                                 | 4. Reducing number of variables by performing principal component analysis, and use the principal components as variables in regressions.  
                                 | 5. Stepwise regression on principal components to identify a smaller set of determinants.  
                                 | 6. Employ more than one regression, but no real solution. |

**Table 1. Comparison of Regression and Data Envelope Analysis**
Data Envelope Analysis

Mathematical programming used to identify best possible performance.

1. Based on selected output to input ratios, does not test for statistical significance of the relationship.
2. Vulnerable to extreme observations and measurement error.
3. Shows each resource-using unit in best light, regardless of the appropriateness of the ratio employed.
4. Efficiency scores improve as number of inputs or outputs included increases.
5. Restricts production relationships to linear, i.e., assumes constant returns to scale.

• Deterministic nature of production frontier has been relaxed by introduction of a disturbance term.
• Use of a priori selection of cluster makes groups of observations more homogeneous.
• Use a priori selection of cluster analysis to balance error.

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Meeusen and van den Broeck (1977) evades this problem by decomposing the error term into two parts. One symmetric component, $v$, is intended to capture random effects from factors outside the control of the individual decision unit. The second, $u$, is intended to capture the effects of inefficiency relative to the stochastic frontier. Unfortunately, this approach does not enable us to obtain measures of technical efficiency by observation, but it can provide measures of average inefficiency over the sample. In this way the model moves closer to the regression analysis approach. While on policy grounds there are clear reasons for preferring frontier models to regression models that predict average expected performance, doubt still remains about their usefulness in practice, particularly regarding the plausibility and robustness of their results.

However, the DEA approach seems to have clear advantages. Unlike regression analysis it has the ability to handle multiple outputs. Also, an important by-product of the technique is its diagnostic ability whereby it can be used to pinpoint particular sources of poor performance in inefficient organizations—referred to in the jargon of DEA as an analysis of slack variables. Certainly, in the growing number of published applications of the technique, it clearly displays enormous potential in measuring public sector efficiency. This is particularly true in areas where there exist a large number of agencies to compare.

A comparison of these two techniques and their most important limitations is summarized in Table 1.

**APPLICATIONS OF QUANTITATIVE TECHNIQUES**

**Health**

Attempts to apply quantitative techniques in this area of public services have been constrained by the measurement problems discussed above. In the past, analysis has been undertaken on performance indicators that have largely reflected activities or processes, such as patients treated, hospital throughput, patient turnover, and detailed costs per treatment. These indicators have tended to describe inputs to the system rather than the outcome. Moreover, they have often proved controversial as indicators of relative performance. For example, the "length of stay" has often been used as an indicator of efficiency. However, variations in the average length of stay among hospitals may not reflect relative efficiency but reflect differences in patient mix, the severity of their conditions, and the availability of nonhospital care opportunities. Indeed, a hospital that killed its patients off faster than others would gain a higher rating by this indicator.
On the other hand, analysis using indicators of outcomes, involving the impact on avoidable deaths from conditions amenable to treatment, is not so easy to find in the literature. Such performance indicators tend to be of three types: (1) population-based indicators, such as standardized mortality rates, where many influences other than health services have an impact; (2) patient-based indicators, such as death rates for those who undertook a particular treatment; and (3) controlled trials where the effectiveness or output of a treatment is assessed by providing it for some patients but not for others in matched samples.

The difficulty in correcting for other determining influences, or in generalizing the findings of clinical trials, has meant that other more imaginative avenues have been explored. One approach, attempted by Rosser (1983), is to construct a psychometric indicator by defining ill health according to two dimensions: an eight-point scale of physical incapacity/immobility and a four-point scale of pain or distress. Each point on the two-dimensional matrix has a score derived from sampling responses, where one year of healthy life scores 100 on the QALY (quality-adjusted life year) index. The impact of a treatment for a given condition is measured by the change in the QALY that it induces. Notwithstanding Williams’s proposal (1985) that the QALY approach be used to compare the effectiveness of alternative health service resource allocations, the approach is not without its critics.

Indeed, the measurement problems in quantifying even intermediate output in this sector has severely restricted the application of the quantitative techniques reviewed above. However, Feldstein (1967) used regression analysis to estimate technical and allocative inefficiency in 177 large nonteaching hospitals in the United Kingdom. Subsequent applications of the technique were carried out by Lavers and Whynes (1978) and McGuire (1987). Unfortunately, the many measurement problems mentioned above have often cast doubts on the interpretation and reliability of these results.

Education

Although the main objective of education is more than the development of basic skills such as literacy and numeracy, the latter skills are more amenable to quantification through objective tests. Conse-
ently, the main quantitative indicator of education output or performance has been education results. With greater ease in measurement it is not surprising that education has been an area that has exhibited many more applications of quantitative techniques than the health sector. However, even here the scope of quantification has been constrained. Most educational systems generate multiple examination results. In practice no indicator is likely to be ideal and no unambiguous widely acceptable way of weighting them to construct a summary index exists. The education system is also characterized by multiple inputs with, for example, many studies differentiating between teaching and nonteaching expenditures. However, it is likely that spending on teaching staff is an inadequate measure of the quantity and quality of teaching. Indeed, it is sometimes suggested that differences in teaching input have little impact on educational outputs. Nonteaching inputs present even more of an interpretative problem. Data, which measure changes over time, or differences between regions, usually tell nothing about differences in the stock of buildings, books, and equipment. Therefore high spending might be intended to compensate for the poor stock of capital or might be a symptom of inefficiency in their use.

Even if these basic measurement problems can be overcome, a primary problem in gauging the relative effectiveness of different educational authorities and schools lies in isolating the influence of important socioeconomic factors, such as the educational qualifications of parents. For example, in one of the leading U.K. studies on the effectiveness of the educational system, the Department of Education and Science (1984) employed as many as 15 socioeconomic explanatory variables. Since the number of possible background variables influencing attainment scores is large (creating a degrees-of-freedom problem), with variables typically highly correlated (the multicollinearity problem), some researchers have used principal components analysis to reduce the explanatory variables to a smaller number of independent variables. However, although such procedures help us apply regression analysis to judge whether a particular education author-

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17In most countries such indicators tell us nothing about cognitive performance at lower levels of ability, for which most examinations are not designed. Nor do they tell us about noncognitive achievement. However, in the United States a number of tests, such as the scholastic aptitude test and the national assessment of educational progress, now exist.

18There have also been disputes over the proper level of analysis and whether pupil-level outcomes should be aggregated to the school level for analysis. This and other methodological problems are discussed more fully in Aitkin and Longford (1986).

19Levitt and Joyce (1987), Chapter 10, report the use of principal components to reduce the number of highly correlated socioeconomic variables to two main independent dimensions, subsequently used in their regressions.
ity's pupils are achieving more or less than we expect, given social circumstances and spending, there are still likely to be difficulties in interpreting the residuals. Normally, regression residuals would be viewed as indicating relative efficiency and inefficiency, after making some allowance for factors outside the authorities' control. However, they may well reflect local practices and priorities that differ from the national average.

The relative ease of quantification in this area has also led to the application of DEA. Jesson, Mayston, and Smith (1987) and Mayston and Smith (1987) report the results of two applications of DEA to the provision of secondary education in the United Kingdom. The latter study was based on four outputs, two resource inputs (teaching and nonteaching expenditure), and three environmental variables. Their results suggested that examination performance is a poor guide to efficiency, and they also illustrate the sensitivity of the results to "outliers." Bessent and Bessent (1980) also have demonstrated the versatility of DEA in calculating inefficiency scores for 167 elementary schools in the Houston Independent School District, with two output indicators, seven resource input indicators, and five socioeconomic characteristics.

**Police**

Attempts to measure police impact on crime have also resorted to these quantitative techniques despite obvious measurement problems. The police face many types of crime, and it is difficult to weight them to reach an aggregate index. In the provision of this service one also encounters many different inputs and input mixes in terms of different types of manpower and resources. Moreover, the definition and measurement of the crime rate is problematical, with important interactions between inputs and outputs. For example, increases in police manpower might induce the public to report more crime, and increased numbers of police on the streets may notice and record more crime, so that there is no guarantee of a negative relationship between the recorded crime rate and the number of police. In this situation analysis has generally concentrated on the number of recorded crimes cleared up as a measure of the intermediate output of policing.

The use of regression analysis in devising indicators of relative efficiency has had to cope with this interdependence between the amount of police manpower, the recorded crime rate, and the recorded clear-up rate. To do so requires a simultaneous equation approach, such as that suggested by Carr-Hill and Stern (1979). They used a three-equation model:
A Recorded Crime Rate Equation

\[ CR = f(\text{clear-up rate, police numbers, various social factors}). \]

The recorded crime rate is partly a function of the clear-up rate (a proxy for the probability of detection), the number of police (insofar as they detect and record more crimes, this number is likely to be positive), and various social factors like demographics and economic conditions.

The Clear-Up Rate Equation

\[ CUR = f(\text{crime rate, police numbers, number of social factors}). \]

This equation indicates that the clear-up rate depends partly on the crime rate (an indicator of work load), the number of police (as an input), and a number of factors influencing efficiency of policing (for example, urban/rural environment).

The Police Manpower Equation

\[ POL = f(CR, CUR, \text{various social factors}). \]

The number of police deployed is dependent on the recorded crime rate, the success in clearing up crimes, and various environmental factors felt to determine policing needs.

Owing to the simultaneous nature of these relationships, the estimation technique of three-stage least squares was employed. Carr-Hill and Stern found that increased police resources do not in themselves lead to lower recorded crime rates (a finding also of Willis (1983)). Also, the crime rate is negatively related to the clear-up rate (confirmed by Pyle, 1983), and police inputs are positively related to the clear-up rate (also found by Burrows and Tarling (1982)). It was also possible to rank regional police forces in terms of the magnitude of their deviations from the regression equations, as indicators of their relative efficiency.

As demonstrated by Levitt and Joyce (1987), the problem of devising indicators of relative efficiency was also amenable to DEA. Indeed, the latter technique allowed more flexibility in the inclusion of additional inputs and multiple outputs. For example, it was possible to deal with the different clear-up rates of different types of crime, to include different policing inputs, and to distinguish between those factors within management control and those not within their control. Furthermore, two sensitivity exercises were performed. The relative efficiency rankings of police forces were compared under differing assumptions of constant and diminishing returns to scale, as well
as the differences in their rankings with respect to input and output efficiency.

**EFFICIENCY AND BUDGETARY PLANNING**

As suggested at the beginning of this paper, the performance-based approach to budgeting is a management-oriented reform, requiring spending departments to focus on what they produce and the efficiency with which they produce it. At least on the surface this reorientation seems to offer even greater scope for the quantitative approaches surveyed above. However, the above review of these techniques and their principal applications highlights some important technical limitations to their more widespread use. The first concerns the scope of these analyses, which has usually been partial in approach. These quantitative methods have been employed primarily in intrasectoral comparisons to differentiate efficient from nonefficient producers of similar services. In this way, efficiency has been defined in a sector-specific manner. This is an obvious limitation for integrating these techniques into the budgetary process, which must allocate resources between sectors. The second limitation concerns the feasibility of these methods. All are bedeviled by the problem of finding acceptable ways of measuring the output of government activities. All face the constraint of data availability and the problem of intangible social impacts that severely circumscribe quantitative analysis. The third limitation concerns the hidden costs of adopting any quantitative methodology in a bureaucracy. One should not overlook the considerable administrative costs and extra demands on skilled manpower in terms of the increased work load in applying these techniques. This point brings us to the more general considerations about the practicality of institutionalizing this methodology.

The more widespread adoption of quantitative analysis seems to require the resolution of a number of conflicts inherent in the performance-based approach to budgeting. The first is that faced by the central budget agency in balancing the needs of decision making with its more traditional objective of holding spending departments accountable for their actions. Implicit in the new approach of allowing spending units more freedom in managing resources to meet performance objectives lies a need for decentralization of controls and decision making. While it provides more flexibility to spending departments in resource management, the central agency must also try, as a price for this new freedom, to make resource managers accountable. Unfortunately, quantitative techniques designed to help central budget agencies to assess performance are unlikely to encompass the
details necessary for day-to-day agency operations. As a result they are unlikely to elicit sufficient commitment by resource managers to make them effective. Thus one has to admit a possible conflict of interest between the central agency and the spending departments. By linking performance to resource allocation, what is foreseen is that the budget will become a contract for performance and lead to the formulation of precise targets. In such an environment any request for increased resources would have to be based on an indication of achievable improved performance. Defense of current resource levels would similarly be based on achieving performance targets, with any unjustifiable shortfall in performance resulting in a cut in available resources. But how is one to achieve a behavioral change on the part of resource managers if the new system risks damaging their agency's budget? How can the center persuade the agency to provide data on performance if it is not perceived to be in its interest? The success of any of these procedures depends on the extent to which incentives within agencies are changed so that economic efficiency becomes a high priority. Agency staff may have their own interests and policy aims, with objectives defined in terms other than efficiency. If this is so, the danger exists that any imposed quantitative procedure will be treated by bureaucrats as just one more hurdle to be overcome by dressing up their budget proposals in pseudoeconomic analyses.

Other conflicts arise from the usual trade-offs faced by economic policy. For example, there is likely to be a conflict between the short-run budget exercise, usually taking place annually, and longer-run efficiency goals. On the whole, short-run demands of economic management often take precedence over longer-run considerations such as efficiency in the provision of public services. For example, the U.S. Civil Service Commission (1972) noted that productivity improvements had been "forced" during the budget process by reducing manpower in face of increased work load. This reduction resulted in a short-run improvement in efficiency, but in the longer term it adversely affected the quality of work and alienated the spending agencies. Also, efficiency in government operations is only one element of a government objective function, and usually a second-order one. In practice the budget process has usually been determined by other macroeconomic considerations. In recent years austerity measures or expenditure containment have dominated the budgeting process with adverse effects on efficiency. For example, budget constraints may have adversely affected capital improvements with the result that outdated equipment has become a characteristic feature of public sector organizations (Grace, 1984).

See Diamond (1977) for further discussion.
Such considerations provide a perspective on the many problems likely to be faced in trying to integrate efficiency concerns with budgetary planning. Certainly, the pursuit of efficiency as an independent goal is likely to be counterproductive. The usually complex budgetary process may be overloaded if efficiency is to be added as an invariable feature in the evaluation of all programs. Rather, a strategy on two fronts could be suggested. The first is the continued encouragement of quantification and improved resource allocation at the sector level. At this level, in the absence of identifiable outputs, measuring efficiency in terms of intermediary outputs is likely to be more useful. Further refinement of the techniques outlined above, and perhaps use of them in combination, or gearing them to the needs of particular sectors, is also likely to prove productive. The second is that there should be concurrent efforts at the central level to develop indicators of the impact of different programs, to form the basis for intersectoral comparisons of efficiency. In this way, there will be some check to ensure that in pursuing efficiency the purpose and activities of spending departments are not in conflict with other objectives. Inevitably, these indicators may have to be partially in qualitative terms and may be used as indicative aids rather than prime determinants in budgetary planning.

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Value for Money: Toward Improved Organizational Functioning

KENNETH M. DYE

INTRODUCTION

I should like to give you at the outset some background on how my office got involved in studies aimed at getting better management in the public sector.

In 1977, Parliament gave my office an expanded mandate. Before then, our legislative audit work was mainly financial attest and authority auditing. Today, our mandate is to determine whether taxpayers are getting value for the tax dollars public servants spend. So we now perform what is called “value-for-money auditing.” It is based on the notion of “due regard.” We are now obliged to report to Parliament cases in which management had not given due regard to factors which would provide value for money. The value-for-money mandate focuses on the concept of economy, efficiency, and effectiveness. It seeks to provide information to Parliament about public service managers’ handling of tasks, going far beyond the more limited notion of financial attest audit.

When I was appointed Auditor General of Canada in 1981, I decided that the office should review its impact on the public service and the Federal Government. I found that we were primarily focusing in our reports on weak management systems. And what struck me most about government was the slow, laborious way of getting results or not getting results. At the same time, I became acquainted with many individual senior public service executives. Despite a lack of results, I was impressed with their intelligence and commitment. This apparent contradiction prompted me to commission a study on the causes of management weaknesses. I felt that we should report to Parliament not only results of poor management performance, but also what caused it.

We did that study and published it in 1983 under the title “Constraints to Productive Management in the Public Service.”
CONSTRAINTS TO MANAGEMENT

When we began our study, a number of people suggested that the cause of poor management performance was to be found in the managers themselves. It was said that public service managers are inherently limited in their competence and commitment. We rejected that idea. The Canadian Public Service comprises about 250,000 people, about 1 percent of all of the population. And these people come from all areas of Canada to work for the Government. We reasoned that it would not be possible to try and select one fourth of a million people who are particularly incompetent and uncommitted, all in one place.

In our view, people who worked in the public service were probably no better or worse than any other Canadians. We therefore rejected the notion that the cause of poor public service performance resides exclusively within the public servants themselves. We went further in our thinking and concluded that if the causes are not within the people, then they probably can be found in the environment in which the public servants have to work.

Our study confirmed that. We reported three main findings to Parliament, three main causes of poor performance:

• First, political priorities have a strong impact on management in the public service.
• Second, there are many administrative rules and regulations that impose severe burdens on management.
• Third, there are few incentives for productive management but many more disincentives.

Let us consider each of these findings.

The first has to do with the impact of political priorities on management practices. In the early 1980s, for example, the Ministry of Transport proposed abandonment of unproductive rail lines in Western Canada. This action would have saved millions of subsidy dollars that could have been diverted to other more productive transportation services. However, when the proposal was made, there was an uproar in the parts of the country affected. Members of Parliament who represented Western Canada were strongly opposed to the idea, calling it a reduction in government services. The outcome of this debate was that the operation of the unproductive railway lines and their subsidy by the Government continued. Political priorities had impacted on productive management.

Our second main finding was that there were many administrative rules and regulations, some of which contradicted each other and some of which were not sensible in specific cases. Let me illustrate with an example from a senior public service executive in Montreal.
This individual had to be in Boston for a series of meetings on a certain Monday at noon. His secretary made travel arrangements through the Government’s central travel services. Unfortunately, there were no more seats on the Monday morning flight, so Mr. Jones (we’ll call him) had to fly Sunday afternoon.

About a week before he traveled, it occurred to him that there might have been a cancellation. He called the airline and found that, indeed, there were some available seats. However, they were first-class seats. This man knew that public servants are not allowed to fly first class. But he asked about the difference in price. The difference was only $17. He then asked his secretary to call central travel services and change his travel arrangements. Instead of flying Sunday afternoon and spending $85 to stay in a hotel, he would fly Monday morning, pay an extra $17, but save $85 by not staying in a hotel. The travel people refused to make the change, because the rule said that flying first class was not permitted. Even though he argued that he was saving money for the taxpayer in the end, the inflexible travel administration prevailed. They said, "Mr. Jones, there is a rule against flying first class, but there is no rule against staying in a hotel."

Jones took the flight on Sunday evening. He paid $85 for the hotel, and he charged dinner. But he also saved $17 by not flying first class. When he told us this story, he made an additional point. The fact that he spent some $80 of taxpayers’ money unnecessarily was regrettable, he said. But what really made him upset was the fact that he was forced to do this. The system compelled him to act against the interest of the taxpayer and against his own intentions.

Our third finding in our constraints study was that there are many disincentives to productive management, but not many incentives. Let me illustrate again. Our fiscal year goes from April until March, and it used to be a fact of life in the last two months of the year that government departments would expend an enormous amount of money on purchases—far more so than during the rest of the year. There was a reason for this. In our system, unused funds are "lapsed." We found that there is a stigma attached to "lapses funds." A manager who lapses funds is often viewed as someone who is not very good at planning. Also, when you do not use all your allocated funds in one year, it may well be that your funds will be reduced in the following year. Managers, therefore, want to make sure that they spend all their money, whether they achieve value for this money or not. This says something about disincentives for productive management. It also says something about the ingenuity of managers. They learn very quickly how to "beat the system."
INCENTIVES

When we prepared the report, there was some argument about the "incentives" part. Some people were saying that public servants do have strong incentives: we pay them reasonable salaries; we pay for vacation and legal holidays; we provide pension benefits; we have a paid medical plan; we have a paid dental plan; and we have other benefits of this nature. It is not true, therefore, that there are no incentives.

But there is another side to this. If you line up all these incentives and look at them, you find that they all have one thing in common: to benefit from them, you have to be away from work. And what do we see at work itself? We see that people are surrounded by rules and regulations; we see that they are not trusted very much; we see that they are discouraged from risk taking and that they are criticized for errors. And then we wonder why people would rather be away from work than at work. If the public service system makes work itself very unattractive and it makes being away from work very attractive, we should not be surprised that people prefer to be away from work than at work.

When we published our report on these constraints, we made some suggestions to the Government. We suggested that managers should be given more authority, and that the Government should take steps to improve the training and development of managers.

IMPROVED AUTHORITY AND ACCOUNTABILITY

On both counts, the Government responded positively. It has designed and implemented a program that we call "Improved Managerial Authority and Accountability." Under this program, the Treasury Board and individual departments agree on results to be achieved and give managers significant autonomy to work toward that achievement. With respect to the development of managers, the Government has set up the Canadian Center for Management Development. Its aim is to foster the development of management competencies and the development of a strong corporate identity, together with the values of responsive and productive service to the public.

This rather unusual study was conducted under our mandate of auditing value and money. It convinced us more than ever that the constraints within a public service system need as much attention as the more conventional aspects of economy, efficiency, and effectiveness. It also convinced us that we have to address value-for-money auditing in a comprehensive and integrated way and not with a fragmented approach.
The study on constraints to productive management talked about the barriers and the burdens that managers are facing when they do their work. It explained some of the underlying causes of less than desirable performance. But we also found during that study that there are some managers and some organizations that perform much better than average. In spite of the constraints, they give satisfactory attention to value for money. We found that and we reported that, but we did not attempt to explain why at that time. About two years ago, we decided to do something about it. We undertook a study to discover the attributes of some of the organizations in government that were considered to work well.

There are many theories why some organizations work well. Some people say that strong leadership is required. Others claim that a clarity of goals is important. Still others insist a strong client demand or good political support are necessary ingredients. Still others assert that it is the adequacy of resources. But there is no agreement. Different people believe different things. No one has a concrete explanation.

We wanted to explore this facet of management to make a fairly definite statement about the attributes that are common in organizations performing well. The idea was not to praise these organizations but to identify and document their attributes. Our hope was that, if we could do this, others might be able to learn from this, do likewise, and thereby also perform well. We realized that such a study was not part of our traditional value-for-money auditing approach. We had in the past looked mainly at weaknesses and inadequacies. However, we also realized that value-for-money auditing is still a very recent practice and that it is necessary to explore different aspects of it for it to grow and mature. We also hoped that such a study would give us additional sets of audit criteria that we would be able to use in future value-for-money audits.

Finally, we wanted to see what response we would get on the part of those we audit: Are we a catalyst or an agent of change, recommending positive action based on good performance, rather than on poor performance?

As was to be expected, there were some reservations when we started this study. We knew it was a high-risk study, because we had never done it before. We knew that there was a possibility of failure if we were unable to put together a coherent and convincing set of study findings in our final report. But we believed it important to advance the frontiers of value-for-money auditing, and we therefore decided to go ahead with the study.

Our first challenge was to select a small number of organizations that are considered to work well. It would have been difficult to make
that selection ourselves. If we were to select and then also to confirm good performance, people might doubt the credibility of our study. We therefore went to senior government officials to try and get a peer consensus on a number of suitable organizations. There was some hesitation at first. Officials did not want to be tied down to making such pronouncements, for fear of embarrassment. In the end, though, we had agreement on a dozen organizations that were considered to be performing well. They were not perfect, but they were working better than the average government department or agency.

**SELECTION OF ORGANIZATIONS**

When we discussed selection, we were careful to point out that we were not looking for one specific element of good performance such as efficiency, or responsiveness, or level of service. We were looking for overall high-performance factors on which senior people could agree. Once we had the list of 112 suggested organizations, we began to discuss the study individually with the persons responsible for these organizations. In the case of a department this would be a Deputy Minister. In the case of a crown corporation, it would be its President.

Our aim was to obtain their active support and collaboration in the study. When we do regular audits, we start out principally on our own terms, whether the auditee finds it convenient or not. In this case, however, we felt that we needed the knowledge, experience, and insights of the organizations’ managers to find out the attributes that contribute to good performance. On that basis, we ended up with 8 organizations that were willing to participate in our study. They opened up their minds and they opened up their files to us; they facilitated interviews with their customers and with their suppliers; and they provided detailed knowledge about their operations.

Let me illustrate the size and the type of work of these organizations. There was Canada Mortgage and Housing Corporation, a crown corporation of about 3,000 people, in business to provide housing to Canadians. There was the National Parole Board. Its purpose is to decide which prison inmates should be released on parole and under what conditions. This organization comprises only a few hundred people that are dispersed throughout the country.

We included the Spectrum Management Sector of the Department of Communications. Its task is to assign, control, and monitor radio frequencies that are used by broadcasting stations, aircraft, ambulances, taxis, and the police. We also included a joint project between the Royal Canadian Mounted Police and the Department of Public Works. It concerned management of the real property of the national
police force. There was the International Development Research Centre. Its purpose is to help developing nations design and develop research facilities in their own countries. We looked at the Bankruptcy Branch in the Department of Consumer and Corporate Affairs, a paper-based operation that processes corporate and individual bankruptcies. The seventh organization was the Bureau of Labour Information, which collects and distributes data about the collective bargaining process in Canada. Finally, we included the office of the 1988 Calgary Winter Olympics. We looked on it as a major capital project that spent several hundred million dollars on construction and facilities, all within budget and on time.

The choice offered a considerable variety in the type of work that these organizations do. Yet our study found that there were certain attributes of good performance that were present in all of them. Let me outline the common attributes that we found.

**STUDY FINDINGS**

There was one overall finding that stands out remarkably strongly. I am referring to the shift from management based on control to management based on commitment that we found in these organizations. In traditional bureaucratic hierarchies, the aim of management is to define the best way to do a job, to set standards for compliance, and to monitor and control people to ensure that they comply. We know that this approach results in efficient production when work is routine, repetitive, and predictable. However, when there is much uncertainty, complexity, rapid change, and high interdependence, this control-based approach loses much of its effectiveness. We found in our study that the organizations performing well have moved beyond bureaucracy. They are able to achieve value for money even in complex and in rapidly changing environments. Our report contrasts this change from the old model to a new, more effective model of management.

The old model reads something like this:

The world is messy. Yet, to manage well, things need to be orderly, predictable, and certain. Therefore, we will create an orderly, predictable, and certain world. And then it will be possible to have effective managers and high-performing organizations.

The view in the organizations performing well that we studied is different. They start with the same premise, but they reach different conclusions:

The world is messy. Hence, to manage well, we need to develop managers who can perform productively even in work environments that are messy,
uncertain, and changing. And then it will be possible to have high-performing organizations.

This change in mind-set and values, from a control-based approach to a commitment-based approach, is the most striking overall finding in our study.

Detailed Findings

We found twelve attributes, which we grouped into four clusters. The first cluster has to do with an emphasis on people. Within that, we call the first attribute, “The Empowering Organization.”

What we find is that the organizations performing well become and remain that way by developing and empowering their people. People are challenged, they are stretched, and they are encouraged, rather than criticized. People in these organizations tend to work not only with their hands, but also with their minds and their hearts.

The second attribute is “The Caring Organization.” These organizations care for their clients, they care for themselves, and they care for their people. There is a strong sense of loyalty, of dedication, and even of compassion. There is a team spirit and a sense of caring that is evident in all their relationships.

The third attribute is “The Successful Organization.” We found that the leadership makes sure that success is experienced. They set goals within easy reach at first to ensure success. This success breeds further success. In the end, it becomes impossible to fail. Success has become part of the corporate culture.

The further cluster of attributes has to do with participative leadership. It is not leadership in the sense of authoritarianism or coercion. Rather, it is leadership in the sense of creativity, of detecting patterns both within and outside the organization, of articulating purpose and mission, and of helping people understand and commit to it. People are not only consulted by the leaders in these organizations, they are invited to participate actively in planning and decision making.

A further attribute in this cluster is “The Becoming Organization.” What we find here is that the leaders envision an ideal type that the organization should be, and they are continually striving toward this ideal. They may never fully reach it, but they are always becoming more and more like the ideal.

The third attribute in this cluster is “The Communicating Organization.” The function of leadership here is seen as communicating, rather than commanding. The leaders inspire and foster communication. They hear, they note, they encourage, they articulate policy and
purpose, they counsel, and they reward. People are informed, and they are aware of what is going on and what is planned.

Our next cluster has to do with innovative work styles. We have as the first attribute here, "The Learning Organization." We find that there is continual self-scrutiny, scrutiny of the environment, and scrutiny of actual performance in relation to potential performance. There are measurements, standards, and reviews. These always serve a productive and understood purpose. Their purpose is to learn how to do things better and how to achieve greater value for money. Their purpose is not to impose controls for the sake of them.

The next attribute is "The Problem-Solving Organization." The organization thrives on identifying and solving problems. Indeed, we found that these organizations view problems not so much as difficulties, but as challenges and opportunities. They are innovative and creative in finding new solutions for greater effectiveness and efficiency, for greater value for money.

The third attribute in this cluster is "The Intelligent Organization." People in these organizations review, consult, and collaborate as a matter of course. They understand purpose and mission. They know what needs to be done and what needs to be measured. They have control and feedback systems as useful tools. In other words, the organization knows how to control itself. It does not depend on some outside body to control it.

Now to the final cluster of attributes. We find that the organizations are strongly supported by their owners. By owners, we mean a minister in a government department, or a board of governors in a crown corporation.

We find that there is a strong goal congruence between the political and the public service levels. We also find that the political will actively supports and reinforces this goal congruence. We said in our earlier study that good politics is not necessarily good management. In the organizations performing well, we find that the two work very closely together for common purposes and aims.

Second, we have in this cluster the attribute of "Strong Client Orientation." We find that people in these organizations focus very strongly on client needs and preferences. They do not focus exclusively on the boss and the hierarchy, but also laterally to the customers. We find that their satisfaction derives from serving the client well rather than from observing bureaucratic expectations and processes.

We labeled our last attribute, "The Concretizing Organization." What we mean here is that the leadership and staff in these organizations are able to talk in concrete terms even about intangible things.
Mission and value statements are written in simple and realistic terms. Abstract events such as zero defaults in the collection of accounts receivable are celebrated through concrete awards. The organizations create tangible symbols of abstract events.

To summarize the attributes, there is the very important emphasis on people. There is participative leadership. There are innovative work styles. And there is strong client orientation. These attributes are present to a greater or a lesser degree in all the organizations we reviewed. We find that they are making a significant contribution to the achievement of value for money.

As for the response to our study, we found within the participating organizations the strong wish to perform even better than they are now. As we made the study, managers asked us not only to document the attributes of good performance, but also to tell them about weaknesses that they should improve. We observed a similar phenomenon in the public service at large after we published the study. Departments were calling us for advice on how they could improve their management to achieve greater value for money.

There is an interesting aspect to these replications. Other countries are only mildly interested in seeing whether they will get the same findings that we did. They are primarily interested in seeing if they can generate the same enthusiasm for improvement in their own civil service that we have been able to generate in Canada.

The attributes study has answered most of the questions we asked. We have a good idea now what are the attributes of government organizations that perform well.

What we still do not know, however, is the mind-set, and what are the values that drive some people always to seek improvement in their organization's performance?

To answer that question, we have started a new study. It is a study to determine the driving elements in organizations. What are the values and what are the value conflicts that influence managers and organizations one way or another in their task to achieve value for money? The report on this study will be completed later.

As indicated at the beginning, value-for-money auditing is still an evolving discipline. There are potential areas in this discipline that are still waiting to be explored. New approaches to achieving and auditing value for money will no doubt emerge in the future. In Canada, we are trying to explore the future so that we are comfortable in it when it arrives. Of one thing we are virtually certain: that the future will be focused on people and on their values.
The Judicial Power of the Purse: How the Courts Interpret Budget Laws¹

DONALD AXELROD

INTRODUCTION

I
n our discussions of the budget process we usually assume that budget making is the sole prerogative of chief executives and legislatures. It is no longer so. Increasingly in many countries the courts intervene in every phase of the budget process at all levels of government. The intrusion may be sporadic, as is true in most countries where the courts are free to interpret constitution and budget laws. Or it may be intensive, as in the United States where court decisions affect budget formulation, appropriations, budget implementation, investment programs, debt financing, intergovernmental grants, legislative-executive relations in budgeting, and the financing of public enterprises. In the latter, possibly extreme situation, the courts frequently determine funding levels, service standards, staffing patterns, salaries, and even budget procedures.

Without a direct role in the budget process, courts have but one point of entry into the fray. Typically, aggrieved subnational governments and individuals file suit in the courts and argue that some budget decisions and programs deprive them of rights guaranteed by constitutions and budget laws. They look to the courts to overturn or modify the objectionable policies.

In adjudicating these issues the courts are called upon to interpret a formidable body of constitutional provisions and budget laws governing the budget process. How far they go depends on the political and legal systems, the administrative culture, and the norms governing the budget process in each country.

Regardless of political systems, however, every constitution lays out the budgeting and financial framework of the country. Admittedly, it is no easy task to keep up with constitutional provisions. As of 1988, 80 new national constitutions were in existence, with over one half approved since 1974. The median age of most constitutions is about 15 years. Frequently the amendments include structural changes in the budget process.

At the national level constitutions generally deal with budget systems in fairly broad terms. They spell out executive and legislative roles in budgeting; divide budget responsibilities and allocate functions between national and subnational governments; apportion revenues such as income, sales, and business taxes between government levels; reserve some taxes such as property and excise taxes for specific levels of government; and control borrowing by subnational governments. Constitutional courts as in the Federal Republic of Germany and France and high courts in other countries may have specific constitutional power to adjudicate budgetary conflicts between national and subnational governments. In other countries such as the United Kingdom the High Court may accrue such powers through custom.

At state and provincial levels where constitutions exist, the budget system may be spelled out in excruciating detail. This is the practice in the 50 state governments of the United States, where constitutions control virtually every phase of the budget process. Constitutions are replete with requirements for a balanced budget; ceilings on taxes, expenditures, and debt; limits on the legislature’s power over appropriations; limits on the governor’s power to veto appropriations; budget procedures that should be followed by legislators and governors; the structure of appropriation acts (lump sums or line items); the format of budget documents; executive and legislative roles in implementing the budget; policies on intergovernmental grants; and controls over taxes, expenditures, and debt of local governments.

Buttressing constitutional provisions in every country are comprehensive budget laws that cover all aspects of budgeting. This is true of Malaysia, Turkey, India, and the Philippines, where budget reform laws not only update budget procedures but lay the basis for program and performance budgeting. Several laws endeavor to strengthen budgeting as a tool of economic management. For example, in the Federal Republic of Germany the Law of Stability and Economic Growth of 1967 and the Federal Budget Act of 1969 empower the Government to borrow funds outside the budget process to stimulate the economy; to raise or lower taxes by executive order; to set aside budget surpluses in anticyclical reserves that would be tapped in a
recession; and to integrate multiyear financial plans of federal and state governments.

In the 1980s budget legislation has endeavored to deal with chronic deficits that bedevil virtually all governments. Some governments have legislated deficit reduction targets. Perhaps one of the most intricate requirements is the so-called Gramm-Rudman Act of the United States, which sets annual deficit reduction targets until the budget is in balance. Should Congress and the President fail to agree on budget reductions, an automatic procedure takes over that cuts most budgets across the board.

Since Congress and the President are equal partners in budgeting, Congress is quick to pass legislation to protect itself against presidential usurpation of its powers. Thus, presidents cannot impound or delay the use of appropriated funds without congressional approval. To match executive powers in budgeting, Congress has devised an elaborate mechanism—the Congressional Budget Reform Act of 1974—to set overall spending, credit and tax targets, and to discipline spending. At the state level in the United States a cornucopia of legislation since the 1970s seeks to control taxes, expenditures, and debt.

Much of the budget legislation in many countries is fairly mundane in nature. It covers the details of budget procedures at all governmental levels.

Inevitably, sharp differences of opinion will arise about the interpretation of the many constitutional and statutory provisions governing budgeting. Where courts are free to act, theirs will be the last word on budget controversies. In Australia, Canada, India, the Federal Republic of Germany, Malaysia, and other countries with federal systems, the courts adjudicate disputes between national and subnational governments on taxation and expenditures. For example, the High Court of Australia ruled that, under the constitution, only the Federal Government and not the states could levy indirect taxes such as sales and excise taxes. Also in Australia the states have with mixed results challenged grants by the Federal Government for road construction and maintenance as intrusions on their powers. In one landmark case, the State of Victoria unsuccessfully attempted to block federal legislation that provided grants only on the condition that states would not increase taxes during the year in which they received the grants.

In the Federal Republic of Germany the state governments have two weapons at their disposal with which to challenge national budget policy such as revenue sharing: (1) they can threaten to appeal to the constitutional court (and the mere threat frequently works); or (2)
they can count on the upper legislative chamber, the Bundesrat, that represents their interests to veto the changes.

Even in unitary systems of government such as the United Kingdom and France, the courts determine the power of local governments to tax and spend. For example, the highest court in the United Kingdom, the Court of Appeals (the House of Lords sits as this court) prohibited the Greater London Council from ordering a borough to raise taxes so that it could reduce fares for mass transportation by 25 percent. In another case a lower court canceled a wage settlement by the Borough of Camden in London on the grounds that it exceeded the national rate of wage increases and violated the Local Government Act of 1982.

**U.S. COURT DECISIONS**

No courts anywhere, however, come even close to the courts of the United States in the sweep of their decisions on budgeting. No aspect of budgeting, procedural or substantive, is beyond their reach. Several factors account for the dominant position of what some critics call the "imperial judiciary": the separation of powers with a fiercely independent judiciary; the proclivity of U.S. society to depend on laws to solve large and small problems; the litigiousness of U.S. citizens; and the trend among disadvantaged groups since the 1950s to seek in the courts the relief denied to them in the political arena. The result is that the courts are de facto equal partners in budgeting with the executive and legislative branches.

Literally hundreds of cases in federal and state courts (we are blessed with two court systems in the United States) highlight the willingness of courts to intervene in budget processes and policies. Some dramatic, albeit not atypical, cases illustrate this trend.

One would assume that the power of the executive to monitor the execution of the budget would be unchallenged. After all, how else can a government cope with unexpected expenditures, shortfalls in revenues, and soaring deficits? But that is not so in the United States. From 1969 to 1973 President Nixon refused to allot some $28 billion in appropriations for 110 programs previously approved by Congress. State and local governments and public interest groups promptly sued the administration in the federal courts to release the appropriated funds.

In about 100 cases before the courts the Nixon Administration tried a variety of defenses: the President’s statutory power to withhold allotments to reduce the need for deficiency and supplemental appropriations; the need to control the national debt and stabilize the economy; the immunity of a sovereign government to suits without its
consent; the lack of court jurisdiction over "political questions"; the President’s obligation to implement the budget as presented by him; and the language in appropriation acts that authorizes but does not mandate expenditures.

These arguments prevailed only in two or three cases. Without raising constitutional issues, the courts concluded that the President lacked the discretion to impound funds in the absence of specific statutory authority. The effect of these decisions was dramatic. Instead of getting $333 million for sewage treatment plants, New York State received $664 million. Similarly, the allotment for New Jersey jumped from $231 million to $462 million. State governors ran into similar problems. Confronted by a projected deficit of $145.4 million in fiscal year 1981, the Governor of Wisconsin cut all allotments across the board by 4.4 percent. The reductions included state aid for schools. Local governments challenged the cuts in the highest court of the state, and the court took a rather curious position. It agreed that the Governor through the budget office had the statutory power to reduce allotments for operating programs. But this power did not extend to state aid for schools. The solution lay in new legislation authorizing cutbacks in state aid for education. Otherwise the cuts constituted an abuse of executive discretion.

The Governor of New York State found himself in a no-win situation in the course of implementing his budget. The constitution of the state requires him to submit a balanced budget to the legislature. Oddly enough, it does not compel him to keep the budget in balance throughout the fiscal year. Nevertheless the Governor set it as his goal. Hence, when the state found itself in fiscal difficulties, he refused to allot funds from several appropriations including $7 million for local sewage treatment plants. Predictably, local governments sued him in the state courts. Ignoring the Governor’s arguments about the need for fiscal restraint and a balanced budget, the highest court stated flatly in language that makes budgeteers shudder:

Under the state constitution, the executive possesses no express or inherent power—based upon its view of sound fiscal policy—to impound funds which have been appropriated by the legislature.

On occasion the courts have the final word on the start-up of major construction programs even though appropriated funds are available. After ten years of litigation a federal court barred the construction of the Westway, a multibillion dollar highway project in New York City. The court rejected the project on two grounds: (1) the Army Corps of Engineers had failed to prepare an acceptable environmental impact statement as required by law, and (2) the Corps was especially lax in analyzing the impact of the project on the survival of a protected fish,
the striped bass, in the Hudson River. In a similar case the Supreme Court enjoined the Tennessee Valley Authority from constructing a dam that might endanger another protected species, the snail darter.

In many state governments the constitutions mandate public referenda on bond issues for capital construction. Such ultimate expressions of democratic rule would appear to be beyond the reach of the courts. That is not so. In 1978, the voters in New Jersey approved a $100 million bond issue for a variety of public works projects. Nevertheless, the state's supreme court ruled that the referendum was unconstitutional, since the state constitution required bond issues to be devoted to a single purpose (for example, transportation) and not to multiple purposes.

On other budget issues the courts have even removed referenda from the ballot. For example, in 1984 the highest court in Florida denied voters an opportunity to approve or reject a measure that would limit tax increases to specified ceilings and require a referendum to breach the ceilings. The court found that, contrary to the state constitution, the measure was not devoted to a single subject and was so broad as to be ambiguous. Similarly, the Supreme Court in California refused to give voters in that state an opportunity to act on a referendum requiring the state legislature to approve an amendment to the U.S. Constitution mandating a balanced budget. (The U.S. Constitution can only be amended by a vote of three fourths of 50 state legislatures or by a special constitutional convention.) The court ruled that such compulsion was unconstitutional since it would prevent legislators from using their best judgment on issues of public policy.

The courts have been especially zealous in adjudicating conflicts that have arisen out of transfer payments. Their decisions affect some $100 billion in annual federal aid to state and local governments and even greater sums representing state aid to local governments. In hundreds of cases the courts have interpreted statutes authorizing grants, determined the constitutionality of some grants, and made certain that the grants complied with across-the-board statutory provisions that govern all transfer payments, namely, standards for civil rights, antidiscrimination in employment, environmental protection, and assistance to the disabled.

Some examples may shed some light on the sweep of judicial decisions. In Chicago, a federal court enjoined the city from using $135 million in federal funds for law enforcement on the ground that in its hiring practices it discriminated against minority groups. In Hartford, Connecticut, the court found that the city rather than surrounding suburban areas was entitled to federal funds for housing. In the court's view, the city, under the terms of the federal statute, had
greater housing needs for low- and moderate-income groups. In another far-reaching case the federal court forced state and local governments to use federal funds to provide access to mass transportation for disabled individuals.

Numerous rulings of the courts go to the very heart of the budget process and deal with such issues as the balanced budget; deficit reduction; the format of the executive budget; the scope and format of appropriation bills; the exercise of gubernatorial veto power over appropriations; and the funding of public enterprises. Again, space and time limitations permit references to only a few tantalizing cases.

In 1985 a politically divided Congress approved an act for the phased reduction of deficits. Should the President and Congress fail to reach agreement on budget cuts, automatic across-the-board expenditure reductions would go into effect. The mechanics would be simple. After consultation with the President's budget office and the staff of the congressional budget office, the Comptroller General, an appointee of the President but a servant of Congress, would advise the President on the amount of cuts that should be made to meet the annual targets for deficit reduction. The federal courts upset this mechanism as an unconstitutional violation of the separation of powers. Since the Comptroller General was a congressional official, it was "constitutionally improper" for him to exercise the executive function of proposing budget cuts to the President. Under these circumstances the automatic budget pilot is still more or less in effect without the participation of the Comptroller General.

In the state of Mississippi a precedent-making case also turned on the doctrine of separation of powers. Loath to give the Governor the sole power to implement the budget, several states like Mississippi created joint executive-legislative committees to approve changes in appropriations in the course of budget implementation. To the Mississippi Supreme Court this action was a blatant evasion of the constitutional requirement for the separation of powers. Hence, two separate bodies to monitor the execution of the budget were set up—one appointed by the Governor and one appointed by the legislature. They do precisely what had been done before, but they now have the blessing of the court.

In submitting a balanced budget, state governors must of course take into account revenue and expenditure estimates. Some years ago a plaintiff argued before the state court in New York that the Governor went too far by including in his revenue estimates the proceeds of future short-term bond issues. Being iffy and speculative in nature, they could not be used to balance the budget. The court, however, approved the estimates providing they were not "dishonest." Only when estimates were falsely contrived to balance what in effect was
an unbalanced budget could they be regarded as unconstitutional. It is somewhat breathtaking to find courts scrutinizing estimates for evidence of questionable manipulation. This could happen only in the United States.

An especially thorny problem in New York and other states is the format of the appropriations bill. This issue is not merely technical, since the structure of the appropriations bill determines the extent of legislative and executive control of the budget. Should the appropriate bill be "itemized," as is required by most state constitutions? If so, what is the meaning of "itemization"? Does the growing use of lump sums in appropriations bills contravene constitutions? This issue surfaced in New York when three legislators asked the court to declare unconstitutional a recently enacted appropriations bill. They objected in particular to the extensive use of lump sums and the power of the budget director to allot funds from lump sums and to transfer funds between them. These powers, they argued, usurped legislative powers. While the highest court took no firm stand, it warned all parties in the case that lump sum appropriations should not be so broad that they nullified attempts by the legislature to control individual items of expenditure.

If budgeteers outside the United States are startled by the extent of judicial intervention in the budget process, they may find especially disturbing the role of the courts in compelling state governments to appropriate funds for numerous programs and projects. The result was that by the mid-1980s many states had overhauled their programs and sharply expanded their appropriations for mental health, mental retardation, correctional services, education, and welfare. This result was due directly to a string of landmark court decisions. And judicial activism shows no signs of abating.

In every case, plaintiffs petitioned both federal and state courts that existing programs deprived them of their individual rights guaranteed by federal and state constitutions. Much of the litigation centered on the Eighth Amendment of the U.S. Constitution, which prohibits "cruel and unusual punishment" and the Fourteenth Amendment, which guarantees equal protection of the laws and due process in all issues affecting life, liberty, and property. Plaintiffs also invoked similar clauses that exist in state constitutions. Invariably, court decisions resulted in modifications of programs and policies. In their rulings the courts for the most part ignored the effect of the decisions on budgets. As one federal judge put it, "the decisions of the courts are legion that cost burden is not a defense to the deprivation of individual rights."

A sprinkling of cases illustrate the judicial role in allocating re-
sources. In the early 1970s a federal judge in Alabama found that programs for the mentally ill and mentally retarded did not meet constitutional standards. As a result, he imposed specific quantitative standards for medical, educational, nutritional, therapeutic, and recreational services. The standards included staffing patterns and proposals to increase appropriations. Virtually overnight the budget in Alabama increased by hundreds of millions of dollars. Furthermore, the Alabama decisions had ripple effects that reached every state.

For example, a federal court in Minnesota agreed that compliance with its decisions would raise budgets for mental health programs by millions of dollars. Nevertheless, it asserted flatly:

If Minnesota chooses to operate hospitals for the mentally retarded, the operation must meet constitutional standards and that operation may not be permitted to yield to financial considerations.

Similar decisions in New York led to budget increases of over $1 billion in programs for the mentally ill and retarded. To put teeth in its decisions the federal court in 1975 issued a consent decree covering the level of appropriations, staff ratios, and service levels. Under political pressure a reluctant governor signed the decree.

Court decisions have been directly instrumental in restructuring prison systems and increasing operating and capital budgets for correctional services in many states and cities. In almost every case the plaintiffs attacked the conditions of confinement as "cruel and unusual punishment" proscribed by the Constitution. As in the cases affecting the mentally ill and retarded, the courts made short shrift of state pleas about the lack of funds. By the end of the 1970s some estimates suggested that the cost of implementing judicial orders ranged in some states to $1 billion or more.

Court decisions have also affected all levels of education and have had a dramatic effect on state and local education budgets. The support of elementary and secondary education represents the largest single component of state and local government budgets. To finance these programs, local governments rely heavily on property taxes augmented by state and federal grants. The result is that school districts with affluent individual and corporate property owners spend lavishly on education. They have the luxury of a large tax base. Conversely, communities with a skimpy tax base spend far less. The disparity in resources between rich and poor communities proved to be anathema to several federal and state courts, which found that the existing system of educational financing violated the equal protection clauses of federal and state constitutions. As the highest court in California put it:
This funding scheme invidiously discriminates against the poor because it makes the quality of a child’s education a function of the wealth of his parents and neighbors.

The court issued a decree that laid down standards for the gradual narrowing of the gap in resources between affluent and poor school districts.

In New Jersey the highest court went even further. Like its California counterpart it called upon state and local governments to change present methods of educational financing. Dissatisfied with the inertia of these governments, the court took a series of drastic actions. It imposed deadlines on the state government to revise the formula for financing education. It ordered provisional relief for poor school districts. Finally, in 1975 it enjoined the state from distributing state aid for education altogether and did not lift the injunction until 1976 when the legislature passed the first personal income tax with the revenue earmarked for education.

Extending their nets even further, federal and state courts in the United States have intervened in almost every aspect of personnel administration, including pay levels, minimum wages, overtime pay, collective bargaining, position classification, and pension benefits. Two cases in particular may indicate the extent to which the courts determine the size of payrolls. In one case the U.S. Supreme Court decided that the Fair Labor Standards Act, hitherto limited to the private sector, controlled overtime pay and minimum wages of employees of state and local governments. This decision added about $4 billion annually to the size of the payroll.

In a related case the highest court of the State of Washington struggled with the issue of equal pay for jobs of comparable worth, not just equal pay for equal work. Women employees who initiated the suit claimed that jobs held by women were undervalued in governmental pay plans. This, they asserted, was a violation of the U.S. Civil Rights Act of 1964. Some $400 million in additional pay hung on the court’s decision. In the end the court supported the state’s policy of basing compensation on pay levels prevailing in the marketplace rather than on complex theories of comparable worth. The issue became moot, however, when the state and the employees’ union agreed on a revised pay plan for women.

ROLE OF U.S. COURTS

Whether chief executives and legislatures in the United States like it or not, they now share budget making powers with the courts. Many do not like it. They attack the courts for usurping the policymaking
and budgeting prerogatives of the executive and legislative branches. In their view, this usurpation leads to an erosion of popular control over the budget process. Especially troublesome is the piecemeal nature of judicial decisions. Unlike elected officials, courts set no overall fiscal and program priorities. They decide issues on an ad hoc basis, depending on the plaintiffs who get to them first. After all, courts do not initiate policy; they act solely on the basis of complaints. By taking a case-by-case approach, the courts of necessity limit their options and ignore the interrelationship of programs and budgets. They are indifferent to the overall effect of their decisions on budgets. As a result, the critics argue that the courts, in what amounts to a zero-sum game, force redistributive budget policies on state and local governments. Compelled by judicial decrees to increase expenditures for some programs, governments have reduced them for others.

On the other hand, the courts do not lack defenders. Supporters see them as the only means of protecting the constitutional rights of individuals. Only intolerable conditions and urgent needs bring plaintiffs to the courts. The courts neither encourage nor initiate such litigation. Frequently, the question before the courts is not "who should do it," but whether anything should be done at all. When the courts act, they exercise their authority reluctantly because no other remedies exist.

The prospects for limiting the judicial power of the purse in the United States are dim. Neither conservative nor liberal courts demonstrate any self-restraint when constitutional issues are at stake. In fact, federal and state governments are inviting more, rather than less, judicial intervention by revising constitutions and statutes to set tax, debt, and expenditure limits and to control deficits. This opens the way for still more court rulings as litigants challenge or seek interpretations of legal provisions.

In the foreseeable future, then, courts will continue to participate in budget decision making in the United States. Policymakers and budgeteers at all levels of government will have to reckon with the impact of judicial decrees.

Admittedly, the role of the courts in the United States in the budget process is an extreme case. At the other extreme are courts in other countries with no role whatsoever. In between are national courts that stand ready to deal with some issues of governmental financing. Should they go further, they can look to the United States as an example of the results of a freewheeling judiciary that has taken on the power of the purse. This may act as a brake or as a stimulant. It all depends on the confluence of political, social, economic, regional, and ethnic forces in each country.
Part II: Country Studies
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Results-Oriented Management: Australian Public Sector Financial Management, Accounting, and Budgeting Reform in the 1980s

PAUL W. McDONALD

THE NECESSITY FOR REFORM

The 1980s have seen an unprecedented series of financial management, accounting, and budgetary reforms in the Australian federal public sector. The rationale for these reforms, their progress to date, and the challenges they pose for the future are addressed in this chapter to provide some insights into the "results or performance-oriented" management approach adopted by the Federal Government. Significant economic reform has also been pursued in Australia during this period and, in a very real sense, it has been linked closely with the financial management and budgetary initiatives of the Government. This nexus is best seen by describing the circumstances that brought about the reform process.

The real impetus for affirmative policy action has been the increasing economic difficulties faced by Australia since the late 1970s, and the realization by the newly elected Hawke Labor Government in March 1983 that macroeconomic policy solutions and fundamental change at the microeconomic level were essential if Australia was to continue to be a modern, developed nation into the next century. Historically, Australia's relatively high standard of living was built upon heavy reliance on the production of agricultural staples and, since the 1960s, a seemingly endless demand by the world for its minerals. However, declining terms of trade for these outputs, the international recession of the early 1980s, and a lack of attention to structural efficiencies combined to bring about the most serious economic situation in Australia since the Second World War.

In response to these difficulties economic policy over the past few years has focused on achieving a sustained reduction in the excessive
terms of trade imbalance that emerged as a result of the international collapse in commodity prices in the previous decade. This situation had a particularly harsh impact on Australia, as a commodity exporter, to the extent that in 1985/86 its current account deficit was over $A 14.8 billion, or 6.3 percent of gross domestic product (GDP), compared with 3.8 percent two years earlier—a level that was both unacceptable and unsustainable.\(^1\) The Government's response to this problem has been to adjust the goals of policy to achieve marked reductions in the current account deficit while maintaining an acceptable level of economic activity and resource utilization within the economy. That approach has borne fruit. The 1987/88 current account deficit was $A 11.9 billion, or a little over 4 percent of GDP.\(^2\) The economy's basic susceptibility to overseas economic forces remains strong, however, and the Government's policy stance acknowledges that substantial further progress is required in this area.

Within this overall macroeconomic policy framework the Government has recognized the crucial necessity for public sector spending restraint to help correct the trade imbalance. Accordingly, it has very substantially tightened fiscal policy to the extent that in August 1988 the Government announced an estimated budget surplus of $A 5.5 billion or 1.7 percent of GDP for the 1988/89 fiscal year.\(^3\) This surplus contrasted dramatically with a federal budget deficit of $A 8 billion or 4.3 percent of GDP in 1983/84.\(^4\) The significance of this turnaround was stressed by the Australian Treasurer, Mr. Keating, in 1988 when he stated that "the real measure of the worth of this surplus is that it includes the combined borrowings of all state and local government authorities and all public sector enterprises ... and means that in 1988-89 the net public sector borrowing requirement will be zero."

Microeconomic policy action since 1983 has included

- removal of inappropriate regulations in the financial sector, floating of the Australian dollar, and simultaneous abolition of exchange control regulations;
- relaxation of many interest rate controls;

\(^2\)Ibid., p. 23.
\(^3\)Ibid., p. 3.
• opening up the banking system to foreign competition;
• removing most foreign investment controls; and
• reducing protection for industry.

The Government is also pursuing structural adjustment across industries by further examining protection, regulation, taxation, labor market operations, and other potential impediments to economic efficiency, such as outmoded port facilities and practices.

In its own backyard the Government set about facing the challenge of doing more with less through a concerted attempt to change the philosophy of public sector management. Previously, the ethos of Australian public administration tended to be characterized as focusing primarily on compliance with rules and procedures designed to control and limit departmental use of resources rather than being concerned with results. The deficiencies of this traditional approach commonly encountered included

• little need to consider the purpose or objective of spending;
• accountability was more closely related to control of expenditure against detailed appropriations than to results achieved from expenditure;
• more concern with analyzing changes from previous periods than with making forward projections and planning ahead; and
• no ready capability for determining the full cost of specific programs.

The financial management and budgetary reforms currently being pursued are designed specifically to address these deficiencies. Indeed, the Government was elected on a platform that placed high priority on reforming government administration. In its policy paper of early 1983,6 the Government promised, in part, to set up a task force to study reform of the financial management and budgetary systems. On assuming office, it established that task force, and in late 1983 and early 1984 White Papers were released setting out government intentions in this area.7

The major focus of the Government's reform package has been the Financial Management Improvement Program (FMIP), which was started in April 1984 to promote and encourage efficient and effective

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resource management in federal government administration. A notable attribute of this comprehensive approach is that it is based on an attempt to diagnose in a systematic fashion the nature of financial management problems. This approach contrasts with the pre-existing view that new bureaucratic procedures can of themselves bring about the required improvements, and it recognizes that a move in the direction of improved financial management must involve a change in attitudes—toward a performance-oriented management approach—instead of the predominantly pre-existing focus on input and control.

The results of a 1984 survey of senior Australian federal public servants illustrated the magnitude of the problem that the FMIP set out to try to address. This survey revealed that 94 percent of managers questioned on financial management practice perceived it as basically spending the total amount appropriated or controlling expenditure against the legal appropriation limit. In short, the previous budgetary and financial management system reflected an emphasis on the stewardship and control of resource inputs and a lack of orientation toward output or performance. Budgets were about spending money rather than achieving the political, social, or economic objectives of particular government programs.

The FMIP, which is being coordinated by the Department of Finance—the central agency responsible for overseeing the Commonwealth’s financial administration, and, more specifically, for financial management and expenditure review and control activities—covers a multiplicity of measures that operate in three broad areas:

- introducing systems techniques that enable management in departments and agencies to focus on results;

- Many countries, particularly in the Organization for Economic Cooperation and Development, have embarked or are embarking on similar programs. All share the twin concerns of improving financial management practices and controlling public spending, with considerable emphasis on accountability and performance. The United States is undertaking numerous initiatives under its Joint Financial Management Improvement Program (JFMIP). Canada instituted its Increased Ministerial Authority and Accountability (IMAA) in 1986, and in the United Kingdom the Financial Management Initiative (FMI), launched in 1982, consolidated and revitalized efforts to improve financial management begun in the 1960s. Within Australia, all the states and the Northern Territory have also moved to improve public sector administration. While none have put in place as comprehensive a scheme as the FMIP, some have made more progress in certain areas. For example, in New South Wales particular emphasis has been placed on performance evaluation, with all departments being required to have a five-year rolling program aimed at improving program effectiveness and efficiency.

• improving the budgetary and regulatory environment by reviewing unnecessary constraints imposed on public sector managers; and
• improving the standards, skills, and practices of resource management on a service-wide basis.

MANAGING FOR RESULTS

Developing a system of “managing for results” has been a key thrust of the FMIP. It can be characterized as providing the tools that will enable departments and agencies to take advantage of the changing environment. Four separate elements of this approach may be identified:

• corporate management;
• program management and organization design;
• management information; and
• program evaluation.

Corporate Management

Corporate management deals with primary management issues that are fundamental to the effective performance of the organization. It establishes the basic rationale for the organization and its broad direction of development and provides the strategic focus for the three other elements of managing for results. The central concerns addressed in the corporate management approach are

• the determination of the broad mission, goals, and strategy;
• the establishment of a program structure based on the corporate goals and objectives;
• the setting of priorities and the determination of resource allocations among programs; and
• the development of the overall management and staff communications framework.

The results-oriented role for managers in the public sector is intended to mirror that of profit-seeking managers in the private sector, although there is a recognition within the FMIP that the former are required to take into account other important objectives such as equity, equality, access, justice, probity, and security. Many techniques similar to those used in the private sector have been and are being introduced to public sector management, but these are often adapted to accommodate the above-mentioned social objectives. Some of these techniques are addressed later in the chapter.
Typically, corporate management starts at the portfolio level. Major changes to the machinery of Federal Government introduced in July 1987 reduced the number of departments from 28 to 18, organized into 16 Cabinet portfolios. The objective of these changes was to provide ministers and departments with the opportunity, and the responsibility, to concentrate on their priorities and the effectiveness of programs, and to decide how best to meet objectives. The changes also allow ministers and departmental managers to allocate and reallocate resources with significantly less central scrutiny than existed in the past. The move to a “portfolio approach” to management is addressed in more detail in a later section.

Most departments have established some kind of “board of management” on an executive decision-making and planning-group basis to examine issues across the portfolio. But this applies solely to the departmental elements. Where statutory authorities are included within a portfolio, they usually operate with a high degree of independence from the departmental head. In some cases, regular executive-level meetings are held to discuss issues affecting all elements within the portfolio, including statutory authorities. Furthermore, most departments have developed a corporate plan and annual reporting frameworks as a major element of corporate management. The extent to which management authority is devolved to those responsible for service delivery in a department or agency is a crucial element of corporate management style. Devolution of management authority from central agencies, like the Department of Finance, to departments has been a central principle of the FMIP. It is equally important for management authority to be devolved within departments and agencies; if managers are to be accountable, they have to have the maximum flexibility to manage their resources.

Results from an FMIP survey concluded in 1988 suggest that substantial devolution is occurring both to and within departments. All departments with significant regional representation indicated, for example, that control over staffing levels and administrative expenditure had been devolved to state director or lower. There were also indications that devolution was being limited in some departments by two factors. One is the scarcity of resource management skills. The other is the unwillingness of some line managers to assume resource management responsibilities, which, in turn, may be at least to some extent a carryover from the traditional administration model, in which resource management was seen as being primarily the role of “management services” units. Time, training, and a willingness to

change attitudes will be necessary for these inhibitions to be removed. The Department of Finance aims to play a catalytic role in this change to the corporate management ethos by monitoring overall progress, helping to develop key elements of the management process, and assisting in the communication of experience between agencies.

Program Management and Organization Design

Program management and organization structure interact closely in management to achieve corporate goals. As such, they are discussed together in this section. Program management seeks to focus attention on results and the achievement of objectives within identified government policies, corporate priorities, and resource levels. It could be said to be an approach to planning, budgeting, implementation, and evaluation that is structured with the focus on results and resource consciousness throughout the process. Managing by programs has introduced a number of useful disciplines, including the requirement to define policy aims and objectives, establish program structures, and determine appropriate performance measures. Although not without cost, these processes have proved beneficial by encouraging agencies to think through what they are trying to achieve, and the best way of getting there. Put another way, they have encouraged a more strategic focus on the structure of the organization, and, particularly, the decision-making process rather than the operational aspects that seem to have taken up so much time in the past.

Organization design is essentially concerned with dividing the work and responsibilities of an organization as coherently as possible to obtain the best performance from individuals and the organization as a whole. Once an organization has worked out its goals, strategy, and program structure, the interest essentially centers on ensuring that the organization design brings these aspects to life in departmental management by:

- translating the program structure into roles and responsibilities for people within the organization;
- establishing effective channels of communication and decision making; and
- devolving authority and accountability to managers.

Departments and agencies have been encouraged, first, to develop program structures around strategic objectives, and then to decide on the appropriate relationship between program and organization
structure. Many have chosen to rearrange their organization structures to fit program structures more closely. The FMIP survey mentioned above indicated that most departments and agencies had undertaken at least minor organizational adjustments to this end. About half of those surveyed stated that changes in their organizations had been "significant"—and six had undertaken a major organizational review to align organization more closely with program structure. For many departments, however, separation of program and organization structure is unavoidable, and the survey provided evidence of this fact: A high proportion of departments and agencies indicated that much divergence existed between programs and organization at one or more levels in the hierarchy.

The introduction of Program Management and Budgeting (PMB) in late 1985 has been an integral part of this aspect of the FMIP. The move to PMB, which has now been adopted in all departments and budget-dependent agencies, reflects the importance of outcomes in contemporary corporate management thinking of the public service. It also provides a commonly accepted information framework that enables all those involved in the public expenditure process to assess program effectiveness and decide where resources could be better allocated. Essential to that framework is the setting of program goals for managers at all levels against which to assess and improve performance and therefore to provide value for money for program beneficiaries and taxpayers alike.

In a recent seminar series on PMB organized by the Department of Finance, most of the participants were from areas involving programs other than corporate services. The discussion indicated a large amount of acceptance of FMIP/PMB principles and the benefits of a results-oriented perspective. Departments and agencies should be able through PMB to improve both corporate management and accountability to Parliament.

PMB has also been instrumental in ensuring that the Government's social programs achieve their objectives efficiently. By having relevant information about program objectives and performance the Government has been able to contain budget outlays by targeting the most needy and then directing programs toward them, and by improving efficiency by avoiding the distortions associated with having loosely defined or loosely administered social programs. Program objectives and performance measures are being increasingly used as the basis for deliberations by parliamentary review committees. The committees are asking for clear statements of what managers are trying to achieve with the funds allocated and for evidence of program effectiveness.
Management Information

The emphasis on managing for results has significant implications for the information needs of both internal and external users. In turn, changes in those information needs imply a requirement to change the existing management information systems. For example, managers at all levels need better internal information on the costs and outputs of programs to assist in resource allocation decisions. Moreover, the Parliament and the taxpayers want external reports to contain information about the effectiveness and efficiency of government operations.

The main centralized information systems operated by the Department of Finance are the Finance Ledger System, the Budget Management System, the Payroll System, and the Staff Monitoring System. Each of these computer systems has been developed to provide comprehensive accounts, payroll processing, aggregate monitoring, and control that encompasses the Department of Finance’s Central Office, its eight mainland regional offices, and overseas regional offices in London and Washington, all of which are linked on line. A number of overseas public sector experts have recognized that these systems provide good service. Although further development of them will continue, it has been recognized that departmental program managers require more detailed and flexible reporting facilities than they can provide. Therefore, the development of most management information systems is being undertaken on a decentralized basis to create systems that will meet the needs of individual managers as well as the statutory reporting requirements of the central systems.

Major issues currently being addressed by various departments and agencies (including the Department of Finance) in developing information systems tailored to individual needs are

- developing common standards;
- encouraging economy of effort linking resource usage and performance; and
- integrating different types of management information.

A brief description of the effort being put into the development of specific performance measures—the second issue above—should suffice to demonstrate the results-oriented requirements of management information under FMIP.

See, for example, the comments of Charles A. Bowsher, the U.S. Comptroller General, and Maurice C. Mould, former Senior Financial Adviser at the World Bank, in Public Fund Digest II, Vol. 1 (1987), pp. 43 and 83, respectively.
As part of FMIP all departments and agencies are required to develop performance measures of both effectiveness and efficiency and report to Parliament on program performance in any or all of three forms: Budget Explanatory Notes, Annual Reports, and Corporate Plans. However, because of the time spent to date focusing on outcome-oriented objectives, the development of performance information has lagged somewhat, although some useful work has been done. Recent hearings of the Senate Estimates Committee indicate that published performance information does not yet provide an adequate basis for the kind of accountability required under FMIP. The Department of Finance continues to work with program managers in departments and agencies to develop more meaningful performance indicators to meet these requirements.

In parallel with the moves to encourage greater emphasis on performance or managing for results in departments while freeing them from unnecessary detailed central controls, similar initiatives are now being applied to Government Business Enterprises (GBEs) such as Telecom, Australia Post, Overseas Telecommunications Commission, AUSSAT, Australian National Line, the Commonwealth Bank, Australian Airlines, and Qantas.

Stemming from concerns of the Government expressed in a June 1986 Policy Discussion Paper that a greater emphasis on performance by GBEs was needed, and from concerns of the management of these enterprises about excessive government controls on their operations, the Government released a Policy Information Paper in October 1987 that had, as a central element, the setting of financial performance targets for each GBE. These financial targets will recognize the particular circumstances of each enterprise, including any community service obligations. Other operational targets relevant to the efficiency of operations are to be established within the framework of GBE strategic corporate plans. The accountability of these enterprises will be enhanced by an improved flow of information to ministers and by reporting of performance against goals, including financial and operational targets, in annual reports to Parliament. Reflecting this change, the 1989 Autumn Sittings of Parliament will be considering an amendment to the Audit Act—the legislation that sets out the basic rules of government accounting—that strengthens the


ability of the Auditor General's Department to conduct performance audits of GBEs.

Complementing this greater emphasis on performance and accountability, the Government indicated a willingness to reduce various controls on the enterprises. These changes will be introduced on a case-by-case basis with a reform package to be negotiated separately for each GBE. The Department of Finance has been directly involved in negotiating these individual packages. In its May 1988 Economic Statement the Government announced details of the reshaping of the transport and communications GBEs in accordance with negotiated packages, providing for more emphasis on performance and enhanced accountability, coupled with modifications to or removals of various strategic and operating controls.\(^\text{14}\)

**Program Evaluation**

The final, and critical, element of managing for results is program evaluation. It is the link between what has been and is being done and what should be done. Recognizing the importance of evaluation, the Government now requires agencies to plan for evaluation and to include "sunset clauses" and evaluation strategies in all new policy proposals.

The first departmental evaluation plans were lodged with the Department of Finance in December 1987. They were of variable quality, with a number of departments requesting assistance in formulating them. In March 1988 the Department of Finance established an Evaluation Task Force to work with and assist departments in evaluation and to identify and promulgate "best practices." The prime objective of the Task Force is to develop a strategy to enhance evaluation in the federal public sector and to assist and encourage departments to pursue evaluation for their own management and priority-setting purposes.

The introduction of such plans requires agencies to plan their evaluation and review processes on a more systematic and objective footing. The emphasis is not so much on a substantial increase in evaluation activity but more on ensuring that such activity is planned and targeted by departments and external evaluators to best effect. In 1988–89 all departments will have addressed the structural elements of PMB for the first time, that is, program structure, performance indicators, and evaluation plans. It now remains to ensure that PMB achieves its objectives and does not simply become a process-oriented

and bureaucratic system like some of its predecessors in other countries. In this regard, the Department of Finance has sought to work closely with departments by providing more information and training on the principles and techniques of evaluation. A Handbook and an FMIP Evaluation Training Module were published in 1987. The development of a comprehensive evaluation approach will certainly require a sustained effort by managers at all levels of public sector administration.

A general FMIP/PMB model developed in the Department of Finance to illustrate the links between these two reforms is shown in Chart 1. It depicts the way in which the various elements of the FMIP interrelate and highlights the integral role that the development of the program structure plays in achieving the improved resource management objectives of PMB and FMIP.

In concluding this section it is useful to consider the progress made so far with the overall system of managing for results. In 1988 a questionnaire was sent to each of the 18 departments and to 13 agencies within the Federal Government. It was designed to provide an overview of progress in a way that was broadly comparable to the “snapshots” of progress shown in the 1986 FMIP Report. Chart 2, which encompasses results from all the departments and 3 of the agencies surveyed, shows that while considerable progress has been made since 1986—particularly with organization design and evaluation—management information and program management still require more attention. Also, it is clear that a good deal of work is still required before all those organizations surveyed have implemented each element of the system.

**IMPROVEMENTS IN BUDGETARY AND REGULATORY ENVIRONMENT**

Changing the budgetary and regulatory environment is the second key element of the FMIP. It is a critical part of ensuring its success. The reforms already mentioned are placing more demands on management to be accountable for the results of their programs, and yet the budgetary and regulatory environment in which they have been operating tended to revolve around inputs to programs and compliance with rules and procedures. Clearly, some changes needed to be made.

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Chart 1. A General FMIP/PMB Implementation Model

Establish steering committee (might include Department of Finance and PSB representatives)

Senior management agrees to PMB/FMIP implementation

(Commitment of agency head(s) and minister)

Form implementation team (might include Department of Finance and PSB representatives)

Development of program structure and program statements

Development of a "blueprint" program structure:
- Fundamental reappraoch of the role of agency and portfolio
- Identification of output and service targets
- Identification of key policy choices facing government
- Identification of means of achieving each key policy choice

"Blueprint" should then be considered in terms of:

Iterative process

- Current planning processes
- Current management processes
- Processes for judging performance
- Consultation:
  - Staff
  - Portfolio agencies
  - Staff associations
  - Central agencies

Organization structures

Information structures

- Resolution of program structure and statements
- Initiation of training in PMB/FMIP applications

Formal introduction of program budgeting:
- Directional appraisal
- Estimates on PMB basis
- Chart of accounts on PMB basis
- Publish program statements
- Explanatory notes on PMB basis

Improved corporate/program planning and management
Chart 2. Managing for Results: A “Snapshot” Based on Key Indicators ¹

Corporate Management
- Agencies whose corporate management committee meets regularly
- and that have a statement of goals or a corporate plan
- and whose allocation of staff and administration funds is broadly consistent with Agency goals or the corporate plan

Program Management
- Agencies that have a program structure approved by the minister or agency head ²
- and that have descriptions and objectives for programs and subprograms ²
- and that have efficiency and effectiveness performance indicators for program elements linked to budget estimates

Organization Design
- Agencies whose organizational structure has been modified to reflect the program structure
- and that have devolved control over administrative expenditure within approved limits to state office directors/branch heads

Management Information
- Agencies whose management information needs have been reviewed in the light of moves to program management
- and whose information system can monitor resource use and results being achieved

Evaluation ³
- Agencies that have a formal policy for evaluating performance of all programs and that have processes to integrate evaluation planning with corporate/program management
- and that have evaluation results linked to the budget, corporate priority-setting, and organization or program changes

¹ Indicates status reported in 1986.
² Indicates the proportion of departments and agencies that have achieved the specified key indicators.
³ 1988 survey of 18 departments and 3 agencies (the Australian Bureau of Statistics, Customs Service, and Taxation Office).
⁴ These elements have been adopted in all departments and agencies.
⁵ There is now a formal government requirement that all departments and agencies plan for the periodic evaluation of their programs.
The Appropriation Process

In addressing the budgetary and regulatory problems the Government has moved away from rigid centralized control of departmental resources to a system that allows departmental managers substantial freedom to allocate resources and to adapt to changing priorities.

The Running Costs System, introduced in September 1986, is a package of measures that embodies the freeing of centralized controls in concert with the introduction of a new accountability for program managers. It provides a method of encompassing in a single appropriation the full current costs of an agency in providing the government services for which it is responsible. It essentially covers all government spending other than transfer payments, grants, or loans.

The package included such other reforms as the consolidation of appropriations for administrative expenses, which, in some cases, reduced the number of appropriation items from more than 20 to 1—making detailed decisions on what to spend, for example, on travel or computer services of consultants entirely the prerogative of departmental management. At the same time, staff budgeting controls have been simplified, with salary control replacing numbers (average staffing level) as the dominant control. Also, under the new arrangements the capacity exists to carry over up to 2 percent of unused administrative operational provisions from one year to another, thereby allowing managers to take expenditure decisions in a more rational environment. In the 1988/89 budget a further extension of this new arrangement was introduced whereby departments were allowed a borrowing of only one year—again with the same overall 2 percent limit—against the following year’s appropriation.

Overlapping the appropriation process is the recent introduction of cash limits on administrative items so that “letting the managers manage” through consolidation of appropriations has been disciplined by the setting of overall limits and the provision of greater certainty—thus “requiring the managers to manage” without supplementation except for a small number of specified items.

Regulatory Improvements

With a view to simplifying and clarifying the detailed body of regulations concerning public sector financial management issued by the Department of Finance, several interdepartmental teams have been reviewing the Finance Directions. Many of the changes recommended have already been implemented, including the charging for goods and services provided between departments and agencies with the object of making the “user pay.” It is expected that this initiative will result in a more “correct” level of demand for government goods...
and services, and, consequently, a more efficient allocation of resources. At the same time it will ensure that the full costs of government activities are taken into account in decisions about the relative priorities of different programs and activities. Two examples illustrate recent moves in this area. The first relates to a decision by the Government in July 1988 that endorsed a range of measures to allow the Australian Property Group of the Department of Administrative Services to operate in a more commercial manner. Among the more important of these measures was that departments and agencies would have to pay market-based prices for services including rent, utilities, and property services in owned, as well as leased, accommodation. The second example was the decision by the Government to move to full-cost charging for capital works and maintenance services based on commercial fee scales for all agencies.

Reforms of the Budget Process

Significant changes in the budgetary processes, for which the Department of Finance has prime responsibility, have taken place since the publication of the White Paper on budget reform in 1984. They aimed at improving resource allocation procedures and encouraging results-oriented management. Specifically, the budget reforms were designed to improve the overall efficiency of the public sector by, on the one hand:

- providing greater autonomy for ministers and departmental managers to set their own priorities within an environment of tight fiscal limits set by the Government;
- reducing the Department of Finance's involvement in the minutiae of departmental resource issues; and
- providing greater stability for medium-term planning by departments;

but, on the other hand by

- expanding the concerns of both the Department of Finance and the departments with program effectiveness and efficiency and accountability;


maintaining the Department of Finance’s responsibility for aggregate expenditure control; and
increasing its responsibility to probe vigorously where additional funds are sought.

The introduction of PMB, the requirement of departments to include program evaluation strategies in the new policy proposals, and the running cost system are all examples of budget reform addressed under previous headings. Several others of significance warrant mention.

Forward Estimates

From the mid-1970s until 1983 an internal Department of Finance report on the forward estimates of budget outlays had been prepared, usually in February, for use by senior Cabinet ministers. This report provided projections of likely costs of current expenditure programs in the absence of policy change and a general indication of likely expenditure trends as a basis for informed discussion of public expenditure patterns and priorities. In 1976 the forward estimates were integrated into the budget cycle, and in practice, the presentation of the forward estimates report to the Government signaled the beginning of the annual budget deliberation process with the forward estimates for the first year evolving into the budget estimates as the budget review and formulation process took place in the ensuing months.

In March 1983, the newly elected Government published the forward estimates. The report, covering the fiscal years 1983/84–1985/86, provided the first comprehensive view ever published of estimated budget outlays for ongoing programs for a period of three years ahead. In April 1984, the Government indicated its intention to continue to publish and develop the forward estimates to assist parliamentary and public scrutiny and debate of budgetary matters. To this end the reports since 1984 have included detailed sensitivity analysis aimed at giving an approximate assessment of the variations in the three-year forward estimates that would result if, for example, the general level of prices or economic activity varied from the levels underlying the estimates. This new addition was included to aid Cabinet ministers further in their early deliberations on the shape of the

forthcoming budget. Following on from this, in 1984, the Government pledged to make future forward estimates reports more program oriented, in line with its move to introduce PMB.

The timing of the publication of the forward estimates was changed in 1985 so that they could be more clearly associated with the budget just submitted. More particularly, the forward estimates published in December 1986 were based on the out-year estimates collected with estimates for the 1986/87 budget, thereby tightening the link between the budget and forward estimates. This process has been formalized further since then, and the forward estimates are now used as the basis for formulating the following year’s budget—subject to savings and other new policy decisions, and changes to economic and other parameters—and also for keeping tight control over future spending. This upgrading of the role of the forward estimates for use as a firm baseline upon which to consider resource allocation decisions has assisted the Government in taking a medium-term view of budget formulation by causing attention to be paid to the implications for future years of current decisions on new policy and savings. The net result is that more stable program funding is possible, which has provided ministers and program managers with greater certainty about forward funding levels. At the same time it has also required them to manage funding commitments over a period of time on the understanding that the forward estimates would represent a ceiling on available future funds.

The forward estimates also strengthen the linkage between budgeting and corporate planning. In disclosing the shape of future budget outlays, the forward estimates provide a firmer basis for strategic corporate planning by departments. Also, decisions in the annual budget context increasingly reflect a medium-term perspective and are based on a concern with results in the longer term rather than in the short term. Strategic corporate planning undertaken by departments should contribute to, and benefit from, this forward view of the world.

Portfolio Approach

Moves to facilitate a greater emphasis on a “portfolio” approach to resource allocation decisions and savings exercises were taken in 1987/88. These efforts were helped considerably by the government changes referred to previously that brought together many complementary program areas under one portfolio. Portfolios have increasingly been given the opportunity to identify how they would achieve target reductions in outlays involving relatively noncontroversial policy changes, and minor programs within the portfolio, and how they
might fund high-priority, new policy proposals through offsetting savings. The Department of Finance actively supports this approach, recognizing that individual portfolios are in the best position to assess their own priorities, to evaluate their programs, and to identify the scope and need for change. Portfolio budgeting is already working well in effecting restraint in portfolio outlays and in modest resource reallocations while reducing the demands on Cabinet time. Major resource allocation decisions, however, inevitably interact with overall budget priorities, targets, and strategies. The scope for devolution is therefore more limited, but portfolio ministerial authority is enhanced by the setting of realistic and credible resourcing targets and by the capacity of portfolios to carry out sound evaluations of the effectiveness of their programs.

Integrating Staff Controls
Since 1984 staff budget controls have been progressively integrated with finance controls. Most staff control functions were devolved to departments while the Department of Finance assumed responsibility for the aggregate control of staff numbers. The money appropriation is now the primary form of aggregate control, thereby ensuring that the staffing implications are reflected when ministerial program proposals are put forward for consideration.

Incentives for Efficiency and Effectiveness
Creating an environment that has built-in incentives for efficiency and effectiveness as one of its hallmarks presents numerous difficulties, not least because of the difficulties inherent in evaluating performance in many public services. However, unless improved performance is rewarded and poor performance is penalized, there is no doubt that the efforts described earlier will result in a less than optimal outcome. Some measures that have been introduced to date have already been discussed in other contexts, including the devolution of authority in the appropriation process. Other measures include

- the introduction of the efficiency dividend under which departments for the period 1987/88-1989/90 have their running costs appropriation reduced by 1.25 percent per annum in real terms on the grounds that improvements in management and technology should yield gains in efficiency, some of which should be returned to general revenue;
- under arrangements currently being put in place some budget-dependent organizations will be allowed to retain a share of new
revenues; while a fully articulated policy has not yet been finalized, some arrangements already exist that allow agencies to share in receipts from the sale of underutilized assets.

**IMPROVEMENTS IN STANDARDS, SKILLS, AND PRACTICES**

Addressing deficiencies in the standards, skills, and practices of resource management represents the third element of the FMIP. Considerable progress has been made in this area over the past six years.

**Cash Management**

Traditionally, policies on credit and debit facilities and the annual patterns of expenditure by public sector bodies have received low levels of attention. It is now recognized that effective cash management has a direct and beneficial effect on the level of government borrowings and thus on budget outlays, including public sector debt interest. Key elements are that all revenues should be channeled into the public account as quickly as possible and that disbursement of funds to agencies should not be made unnecessarily in advance of need.

A number of specific initiatives—which have realized savings in the hundreds of millions of dollars—have been taken in line with the overall policy on cash management, including:

- fine-tuning of estimated cash flows and a backup overdraft facility with the Reserve (that is, central) Bank to facilitate lower average cash holdings and, consequently, lower levels of government borrowing;
- negotiation of commercial rates of interest on Reserve Bank accounts;
- increasing the facilities for electronic funds transfer both into and out of the Public Account, the Commonwealth’s major account domiciled with the Reserve Bank; and
- active intervention by the Department of Finance’s overseas regional offices to reduce cash balances in overseas bank accounts to an efficient operating level.

**Improved Accounts Processing**

As part of the structural and environmental changes brought about through the reform process the Government embarked on an extensive program of efficiency scrutinies to analyze critically selected areas of government operation. Under the leadership of a prominent senior private sector executive, the Efficiency Scrutiny Unit was es-
established in 1986 to undertake this review. The scrutiny process has had a useful impact on the public service in raising the profile of efficiency improvement and in helping to foster an acceptance of more radical or innovative approaches to management. In short, it has helped focus attention on performance.

One of these reviews, the Efficiency Scrutiny on the Processing of Accounts, was established to examine all aspects of the processing of government accounts with the object of ensuring that the efficiency of processing is maximized and that payment is made by the due date. Equal regard was given to the objectives of ensuring that the best commercial practices were part of the procedures and that consideration was given to public accountability, legislative and procedural implications, risk management, and cash management.

An important recommendation from the scrutiny, agreed to by the Government, was that departments use corporate credit cards whenever possible to pay for goods and services. The Commonwealth contract for the Commonwealth Corporate Credit Card, with Australia’s largest retail bank, began in November 1987 and runs for two years. It is, in essence, a period contract under which a department may seek specially designed “Mastercard” credit cards to be issued to authorized persons to purchase, and/or pay for, goods and services on its behalf. It is a true corporate credit card, and liability for the charges incurred on it is intended to rest with the department, not the individual cardholder. Adequate controls have been put in place to prevent, or at least minimize, fraud, and a monitoring system has been introduced and is working well. Use of the card is expected to ensure that the Commonwealth’s payments to suppliers are discharged promptly, and, in addition, it should reduce the number of claims—particularly small ones—because they will be consolidated on a single monthly account and therefore reduce check issues.

**Risk Management**

The adoption of the central recommendations of the processing of accounts scrutiny represents a radical, but sensible, approach to risk management. It has meant moving from a regime of risk avoidance at any cost—where dollars may have been spent to save cents—to one of balancing the administrative costs of checking claims for payment against the potential for fraud or overpayment arising from the reduction in checks. As a result of a major review of fraud against the Commonwealth the recent Government has required all departments to carry out risk assessments and to prepare fraud control plans. A risk management approach is an important aspect of the preparation of these plans.
While the Department of Finance is strongly committed to promoting a risk management approach to public sector financial practices, this does not mean that "anything goes." In making judgments about risk, and in tailoring controls and checks to the degree of risk involved, managers are held accountable for these decisions, which will be reflected in the extent to which there are errors or breaches of probity, and which need to be evaluated in the light of the additional efficiencies or savings achieved by a lower degree of checking. Risk management does not mean, however, that such errors or breaches are considered likely. It is designed to keep them at an acceptable level rather than to incur what may be the substantial costs of avoiding them totally.

**Asset Management**

A major emerging issue is that of promoting improved asset management. The proper treatment of assets is a widely recognized problem of government financial management. Cash-based accounting is used by all departments and many budget-dependent agencies. Under this system the cost is taken into account when the money is spent (as a full charge in that year’s budget). Asset registers are maintained, but for most noncommercial organizations of government only historical values are recorded. When assets are sold all revenues are paid into consolidated revenue. This system means that managers have relatively poor information and very little incentive to use existing assets efficiently.

Several measures are being taken to overcome these problems:

- commercial and quasi-commercial agencies of government are required or are being encouraged to prepare their financial accounts on an accruals basis and to use current costs for asset valuation;
- guidelines on departmental financial statements for inclusion in annual reports require statements of assets and liabilities valued on a current cost basis; and
- sale of surplus assets is being encouraged in certain cases by allowing a share of the revenue to be applied to an agreed development plan.

This action is intended to ensure that managers are aware of the value of assets under their charge, are accountable for these assets, and have some incentive to utilize them as efficiently and effectively as possible.
Procurement Practices

Following a recent review of procurement in the Commonwealth by the Efficiency Scrutiny team, the Government decided to reduce central control over procurement activities. The review team recommended that departments establish their own procedures and take responsibility for cost-effective purchasing within service-wide guidelines. The system itself had become process bound and oriented toward risk avoidance. The recommended changes are a move toward a performance orientation with scope for flexibility, initiative, and judgment.

Training

The changes to the procurement practices just outlined point to the obvious need to provide training in good purchasing practice. Indeed, one of the consequences of these many changes to our management practices has been a strong need for training in resource management skills throughout the public service. This need has been met partly through the Department of Finance organizing hundreds of sessions, courses, seminars, and workshops and preparing FMIP training modules and developing resource management training packages for departments, with their assistance. Furthermore, program management seminars have recently been run by the Department of Finance to give senior managers the opportunity to discuss their experience in implementing PMB.

Uniform Accounting Practices

While the moves to annual reporting and evaluation plans have improved the availability of information to Parliament and the public for both budgetary decision making and for satisfying accountability requirements, they have not overcome all the problems. For example, the absence of uniform accounting practices across all public sector reporting entities makes it difficult to make comparisons of financial performance. There are also problems in some of the traditional public sector accounting practices, such as the reliance on cash accounting in the budgeting system. Some progress has recently been made from within the public sector (for example, asset management).

Assistance with these perceived problems has also come from the private sector in recent years. The two professional accounting bodies in Australia—the Australian Society of Accountants and the Institute of Chartered Accountants—established the Public Sector Accounting Standards Board (PSASB) in 1983 to
• parallel the activities of the Accounting Standards Board of the private sector in developing standards for the public sector; and
• provide a means for coordinated development of consistent public sector financial reporting.

The PSASB has been quite active since it was established. It has introduced several accounting exposure drafts on a wide variety of issues relevant to public sector financial reporting, including:
• objectives of financial reporting;
• accounting for the revaluation of noncurrent assets;
• accounting for leases; and
• accounting for construction contracts.

In addition, since December 1985 the PSASB (in conjunction with the Accounting Standards Board) has issued several Accounting Guidance Releases, which are designed to provide guidance on certain financial reporting issues.

Other issues that are currently being examined include
• compliance reporting in the public sector;
• application of existing statements of accounting standards to the public sector;
• auditing in the public sector;
• financial statement audits in the public sector; and
• regularity auditing in the public sector.

It is to be hoped that these changes will greatly improve the consistency and standard of reporting to ensure all users of public sector reports are provided with both meaningful and useful information.

FUTURE DIRECTIONS

Significant progress has been made in Australian federal public sector financial management and budget reform over the past six years. Senior managers no longer see resource management as largely a matter of adhering to budgetary limits, and questions of budget and performance are no longer regarded as matters for corporate services group accountants. In general, program managers are now results oriented and accept responsibility for cost-effective management. Nevertheless, the most recent report on the FMIP indicates clearly that, despite the considerable strides since its inception, the reform task has just begun. It points out that the major task is to see that the reforms deliver at the departmental working level.  

In this respect the Department of Finance has two key roles. One is to ensure that the budget and financial system continues to facilitate change and that the Government's requirements for timely, consistent, and relevant information for decision making are met. The other is to act as both a catalyst and a conduit for efficient and effective practices and procedures that will not only support the overall system but also enable managers to manage. In this context, the Department will be working closely with agencies to refine the development of performance measures, of both a quantitative and qualitative nature, which individual managers will not only use for their own purposes but through which they will also be prepared to be accountable to ministers and the Parliament. Such measures will be essential for program evaluations as a basis for the economy, efficiency, and effectiveness of the Government's programs. Also, they will be needed to determine if the programs continue to be appropriate to changing circumstances. Judgment is going to play a large part in this process, but the aim is to achieve informed judgment that will facilitate the setting of priorities and the allocation of resources. One of the key challenges still to be addressed is the development of performance information and associated targets and benchmarks, which can serve the needs of parliamentary scrutiny, government decision making, and departmental management. Initially, at least, these challenges seem certain to be directed toward the organization rather than the individual, but there has also been serious discussion on the need to provide individual incentives such as performance pay, and some moves in this direction may be forthcoming in the future. Similarly, continuing skills development through appropriate training programs will be required. Individual departments ultimately have responsibility for resource management training, but central agencies, particularly the Department of Finance, will continue to play a coordinating role and provide key skills to assist in the design and implementation of departmental programs. There is also an obvious necessity for further development of management information systems—in both the central bodies and the departments and agencies—and in this connection the immediate future will no doubt continue to be affected by the advance of technology.

Accrual accounting methodology will be adopted increasingly into the various businesslike activities of government and in modified form for departments and budget-dependent agencies, though it is not likely to be introduced into the budget. There will be greater concern with cash management as well as asset management, including the valuation of our assets. Where applicable, there will be concern with appropriate rates of return and the question of community service obligations and financial risk. Finally, developments overseas
in public sector accounting, financial management, and budgeting will continue to be monitored closely so that good practice from outside the Commonwealth can be evaluated, modified where necessary, and introduced where appropriate.

Underlying all these future directions is the general acceptance of the need for a continuation of a performance/results-oriented management style that concentrates on output and outcome rather than just on resource inputs and spending within parliamentary appropriations.
The Canadian Experience

INTRODUCTION

Canada has three levels of government that serve 27 million people in a country of massive geographic proportions—it is the second largest in the world after the Soviet Union. There is one federal government, ten provincial governments, two territorial governments, and over 5,000 local governments. Because of Canada’s vast size and relatively small population, its governments historically have played a vital role in financing and building transportation, communication, and power infrastructure.

The federal and provincial governments have exclusive lawmaking powers in different areas. However, there is some overlap. The Federal Government is responsible for peace, order, and good government. It has exclusive legislative powers in international affairs, defense, currency, and interprovincial and international trade and commerce. Provincial governments are responsible for laws respecting property, civil rights, and health, education, and welfare. Local governments are creatures of provincial governments. They provide fire protection, police, sewer and water, and other services associated with running cities and towns.

Canada’s system of government can be described as a federation of constitutional monarchies. The federal and provincial governments are parliamentary democracies adapted from the British model. Each has an elected legislature and an executive—headed by a prime minister or premier, and a cabinet—who are members of the political party in power. A governor general acts as the Canadian head of state; this function is carried out by lieutenant governors at the provincial level. There is also an independent judiciary.

All three levels of government are tied together in fiscal arrangements that include systems of corporate and personal income tax

1Prepared by the staff of the Office of Auditor General of Canada.
revenues, equalization payments, and program cost sharing. For example, the Federal Government has the power to raise funds by any means or system of taxation including customs duties. The taxation powers of provincial governments are limited to "direct" taxation, such as income, property, and retail sales taxes. An example of program cost sharing is transfer payments from the federal to provincial governments to ensure a national standard of health and education.

The remainder of this chapter deals with the Canadian Federal Government. Accounting and financial management practices for provincial governments are similar to practices at the federal level; municipal governments are quite different.

INSTITUTIONS AND THEIR ROLES

The financial accountability of the Federal Government has its origins in British parliamentary tradition. There is a single Consolidated Revenue Fund (CRF) into which all federal receipts must be deposited and out of which all federal disbursements must be made. Disbursements can only be made if spending authority has been provided by Parliament.

Each year, the Houses of Parliament receive three sets of documents containing information that is important to control of the public purse. The first set comprises the Budget Papers, which relate government revenues and expenditure plans to the economy. The second set consists of the Estimates documents, which constitute the Government’s formal request to the legislature for spending authority. The third set, called the Public Accounts, are tabled last and show actual spending compared with amounts authorized, and overall financial position and results. In addition, there are hundreds of financial documents prepared by departments and agencies and tabled regularly in Parliament.

At the federal level, three key central departments are concerned with government accounting and financial management. Under the direction of elected ministers, the Department of Finance prepares the Budget Papers, the Treasury Board assembles the Estimates, and Supply and Services Canada (SSC) prepares the Public Accounts. A Financial Administration Act (FAA) sets out basic principles for financial administration.

Under the FAA, the Treasury Board is responsible for financial management within the Government. The Board has two agencies—the Secretariat and the Office of the Comptroller General. Both are headed by nonelected officials with the rank of deputy head. The Secretariat puts into effect the policies set by the Board and is responsible for overall management of human and matériel resources. The
Office of the Comptroller General ensures the establishment and maintenance across government of sound policies and practices in financial management, program evaluation, and internal audit.

The Minister and the Department of Finance are assigned responsibility by the FAA for the management of the CRF, the Government’s bank account. The Department of Finance is also responsible for control and direction of all matters relating to the financial affairs of Canada not by law assigned to the Treasury Board or to any other minister. Most important, fiscal policy is a Department of Finance responsibility; monetary policy is the responsibility of the Bank of Canada. In addition, the Minister of Finance has authority in areas concerning the buying, holding, or selling of securities, management of the public debt, government-owned corporations (called crown corporations) and, with the President of the Treasury Board, the accounting policies that the Government uses and the form of the Public Accounts.

The Minister of Supply and Services is designated the Receiver General for Canada by the Department of Supply and Services Act. The significant statutory responsibilities of the Receiver General are set out in the FAA. These responsibilities include

- establishing and maintaining bank accounts with financial institutions that, taken together, comprise the Consolidated Revenue Fund;
- issuing all disbursements;
- maintaining the central accounting records for the Government as a whole (the accounts of Canada); and
- preparing the Public Accounts.

Under the FAA, the accounts of Canada are to show

- expenditures under each appropriation (authority by the legislature to make payments);
- revenues;
- other payments into and out of the Consolidated Revenue Fund; and
- such assets and direct and contingent liabilities and related reserves as, in the opinion of the President of the Treasury Board and the Minister of Finance, are required to present fairly the financial position of Canada.

The FAA also assigns responsibilities for financial administration to ministers or deputy heads of the 100 or so other departments and agencies that provide goods and services to the public. These responsibilities include ensuring that
an adequate system of internal control and audit exists;
commitments are only entered into if related payments will be covered by appropriations;
appropriations of a department are only charged when requisitioned by the department's minister or a departmental employee authorized by the minister;
requisitions are not made that would result in expenditures in excess of an appropriation; and
payments are not made unless work has been performed, goods supplied, or services received.

The authority to issue checks on the CRF is concentrated by law in the Receiver General, the Minister of Supply and Services. Consequently, for disbursements, departments provide SSC with check requisitions, and SSC prepares and issues checks and posts the general ledger. By law, departments deposit all cash received in the central CRF and advise SSC for posting to the ledger. Departments also make noncash journal entries for a variety of reasons, and forward them to SSC for posting. All supporting documentation for disbursements, receipts, and journal entries is maintained in the spending departments. These departments also maintain separate management information systems.

The Government’s external auditor is the Auditor General of Canada, a nonelected official who makes reports to the legislature and is independent of the government of the day. The auditor’s Annual Report, together with the Public Accounts of Canada, are reviewed by the House of Commons Standing Committee on Public Accounts. The Public Accounts Committee holds public hearings, attended by the Auditor General and departments that have been audited. The Committee tables reports in the House of Commons containing recommendations to correct problems that have been identified. Under House of Commons rules, the Government must respond within 120 days to any recommendation made by a Committee of the House.

The Auditor General Act, the FAA, and certain other legislation set out the Auditor General’s duties. The duties include (a) attesting to the Government’s summary financial statements and the financial statements of many government boards, agencies, and corporations (some boards, agencies, and corporations are audited by private sector firms); (b) identifying and reporting significant instances where the Government has not complied with appropriation acts, where public funds have not been spent with due regard for economy and efficiency, and where satisfactory procedures have not been put in place to measure and report the effectiveness of programs (where such procedures could reasonably exist and be put in place); and (c)
for certain government-owned corporations, attesting to whether control requirements specified in the FAA have been met—that assets are safeguarded and controlled, transactions comply with relevant laws and regulations, resources are managed economically and efficiently, and operations carried out effectively. This duty of attesting to corporate controls was introduced in 1984 through amendments to the FAA designed to strengthen control and accountability of crown corporations. Such audits are to be carried out at least every five years. The audit opinion is submitted to the Board of Directors unless matters raised also warrant reporting to the minister responsible or to the minister and Parliament.

**STRUCTURE OF ACCOUNTING SYSTEM**

As explained above, SSC maintains the Government’s central accounting records and bank accounts and issues all checks. The approximately 100 departments and agencies that supply goods and services provide SSC with check requisitions, a record of cash received, and a variety of noncash journal entries. The departments and agencies maintain separate management information systems.

The Government’s stated accounting policies may be thought of as “modified cash based.” Revenues are reported on the cash basis and expenditures on the accrual basis. Fixed assets and inventories are expensed when acquired. Reported assets are limited to financial assets—cash, loans, investments, and advances. Throughout the year, transactions are recorded by SSC on the cash basis. Expenditure is adjusted to the accrual basis after the end of the year. An overall asset valuation allowance account is maintained to ensure that total assets are reported at realizable value. The valuation allowance is not allocated to specific assets and its composition is confidential. Inflation accounting is not used in the central accounting system.

In the central accounts, revenue is classified by type, such as personal and corporate income tax, customs and excise tax, and return on investments. Expenditure is classified by appropriation or vote (authority to spend). Generally speaking, there is one central account for each vote. In addition, the coding of disbursements and journal entries allows expenditure to be reported by “envelope,” department, program, activity, and standard object. The “envelope” display is a form of functional reporting related to the Government’s overall resource allocation process. As explained in the section on major problems and recent efforts, this process is undergoing significant change. Reporting by “envelope” will likely disappear in 1990.

The central accounts include all government activities except for those carried out by government-owned corporations, called crown
corporations. Although the central accounts include loans to, and investments in, crown corporations and interest and dividends received from them, the accounts do not include corporate assets, liabilities, revenues, and expenses. The separate financial statements of crown corporations are not consolidated into the Government's general ledger. Generally speaking, the financial statements of crown corporations are based on full accrual accounting principles as opposed to the modified cash principles employed by the Government.

The Government's central accounting system is maintained by SSC in electronic form. Central agencies are now reviewing this 20-year-old system and studying how it may be updated to incorporate current information processing technologies. Management information systems maintained by departments and agencies reflect a variety of forms—from manual to sophisticated electronic.

**FISCAL REPORTING**

The primary financial document in the Federal Government is the Fiscal Plan prepared by the Minister and the Department of Finance. This document is generally prepared in the period July through January, and sets out what the Government plans to spend in the fiscal year beginning April 1, with related revenue and borrowing requirements. Generally, the Fiscal Plan is tabled in the House of Commons in February as part of the annual Budget of the Minister of Finance. The Budget is debated in the House and normally adopted as tabled without change.

The Estimates documents, prepared by departments and agencies and assembled by the Treasury Board Secretariat, provide details of expenditure plans within the overall expenditure framework set out in the Fiscal Plan. The Estimates are tabled in the House of Commons after the Budget, and are referred to a number of Standing Committees of the House for scrutiny. Usually, the Estimates are referred back to the House and adopted without change. The Estimates are structured in three parts. Part I provides an overview, Part II contains proposed wording for appropriation (authority to pay) legislation that Parliament will be asked to approve, and the approximately eighty Part III's set out detailed information on the activities and expenditures of each government program. In addition, Supplementary Estimates are tabled at least twice each year to obtain Parliament's approval for changes in spending.

The Public Accounts are prepared by Supply and Services Canada, and are usually tabled in the House of Commons by late October, some six months after the March 31 fiscal year end. They are referred to the Standing Committee on Public Accounts for scrutiny. The Pub-
Public Accounts are produced in three volumes. Volume I presents a summary analysis of the financial transactions of the Government, including a financial overview, audited summary-level financial statements for the Government as a whole, and supporting analyses of revenues, expenditures, assets, and liabilities. Volume II is presented in two parts. Volume II, Part I, parallels Part II of the Estimates, and focuses on the source and use of appropriation authorities by department or ministry. Volume II, Part II, presents additional information and analyses, such as separate financial statements for various governmental entities and details of certain payments made during the year. Volume III contains the audited financial statements of crown corporations (government-owned corporations).

Under the FAA, the Minister of Finance and the President of the Treasury Board are jointly responsible for setting the Government's stated accounting policies. These accounting policies are used by government officials in preparing financial information for inclusion in the Budget, the Estimates, and the Public Accounts. The FAA also gives the President of the Treasury Board authority to determine disclosure in the Public Accounts, and requires the Accounts to include audited summary financial statements that "present fairly" the Government's financial position, revenues and expenditures, and contingent liabilities. The Auditor General of Canada is required by his Act to examine and report on the summary statements annually.

Overall, the Government routinely provides the legislature with a considerable amount of high-quality financial information each year. Budget documents include the Fiscal Plan referred to above, the Budget Speech, and related publications that focus on issues of significance at budget time. The Part III's of the Estimates are designed to provide committees of the legislature and others with detailed information respecting spending intentions and past performance. And the Public Accounts contain audited financial statements for the Government as a whole, something rarely seen in financial reporting by national governments. The provincial governments in Canada also publish audited summary financial statements.

The federal and provincial governments prepare their audited financial statements in accordance with accounting policies that each has developed. These policies differ from government to government. As a consequence, it is difficult for those who use the financial statements to compare one government with another. It is also difficult for those who prepare and audit the financial statements to know when the statements are presenting information fairly and when they are not.

In March 1981, the Canadian Institute of Chartered Accountants established the Public Sector Accounting and Auditing Committee
PSAAC is seeking to develop generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) for federal, provincial, and local governments in Canada. As of November 1988, it had issued five pronouncements on accounting and four on auditing. Accounting pronouncements deal with disclosure of accounting policies, objectives of summary financial statements, general reporting principles and disclosure standards, the reporting entity, and employee pensions. In addition, PSAAC has conducted a research study on recording and reporting of physical assets and is examining how governments should account for and report transfer payment programs. Auditing pronouncements provide an overview of auditing in the public sector and also deal with the audit of government financial statements, compliance with authority, and value for money.

At the time of writing this chapter, the Canadian Federal Government had adopted some but not all of PSAAC’s accounting recommendations. The Auditor General’s opinion on the Government’s summary statements contains three significant reservations. They include concerns with the reporting entity and with the recording and reporting of employee pension obligations.

A related development was the publication in 1986 of the results of a two-year Federal Government Reporting Study (FGRS). This study was conducted jointly by the Office of the Auditor General of Canada and the U.S. General Accounting Office. Its purpose was to identify the financial information users need about federal governments. The results of FGRS have been provided to Canadian Members of Parliament, government officials, and PSAAC.

The main finding of FGRS was that the Government should publish a comprehensive but concise annual financial report, similar to annual reports published by corporations in the private sector. Such a report was seen as valuable in helping parliamentarians and others obtain a complete picture of government without getting buried in massive amounts of detail. It would also serve as a key to the more detailed information the Government provides in other financial documents. The Government is considering publishing such an annual financial report.
MAJOR PROBLEMS AND RECENT EFFORTS

Financial control was built into legislation as soon as Canada became an independent country. Various laws have been passed since then to improve control over public funds. Also, two recent Royal Commissions reviewed financial management and control as part of their mandates. Table 1 shows the historical development leading to current practices.

The Royal Commission on Government Organization, 1962

This study (commonly referred to as the Glassco Commission) laid the framework for the current organization of government operations. The Glassco Commission’s mandate was to recommend changes that would promote efficiency, economy, and improved service. The philosophy underlying its recommendations has often been summed up by the phrase ‘‘let the managers manage.’’

Table 1. Major Legislation and Studies on Financial Management and Control Since Confederation

<table>
<thead>
<tr>
<th>Year</th>
<th>Act/Commission</th>
<th>Key Points</th>
</tr>
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<tbody>
<tr>
<td>1867</td>
<td>The British North America Act</td>
<td>- created the Consolidated Revenue Fund</td>
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<tr>
<td></td>
<td></td>
<td>- established departments as responsible for managing their own finances</td>
</tr>
<tr>
<td>1878</td>
<td>The Public Accounts Audit Act</td>
<td>- created the Office of the Auditor General</td>
</tr>
<tr>
<td>1931</td>
<td>The Consolidated Revenue and Audit Act</td>
<td>- created the Comptroller of the Treasury</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- created the Treasury Board as the major central control agency of govern-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ment, reducing independence of departments</td>
</tr>
<tr>
<td>1951</td>
<td>The Financial Administration Act</td>
<td>- replaced the 1931 Consolidated Revenue and Audit Act</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- strengthened responsibility of Treasury Board for financial management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- initiated financial reporting for crown corporations</td>
</tr>
<tr>
<td>1962</td>
<td>The Royal Commission on Government Organization (Glassco)</td>
<td></td>
</tr>
<tr>
<td>1969</td>
<td>The Government Organization Act</td>
<td>- abolished the Comptroller of the Treasury and central controls</td>
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<tr>
<td></td>
<td></td>
<td>- granted autonomy to the Treasury Board Secretariat (from Department of</td>
</tr>
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<td></td>
<td></td>
<td>Finance)</td>
</tr>
<tr>
<td>1976</td>
<td>The Auditor General reports concerns about control</td>
<td></td>
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<tr>
<td></td>
<td>of the public purse</td>
<td></td>
</tr>
<tr>
<td>1977</td>
<td>The Auditor General Act</td>
<td>- gave the Auditor General authority to report on value for money</td>
</tr>
<tr>
<td>1978</td>
<td>Amendment to the Financial Administration Act</td>
<td>- created the Office of the Comptroller General</td>
</tr>
<tr>
<td>1979</td>
<td>The Royal Commission on Financial Management and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accountability (Lambert)</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>Amendments to the Financial Administration Act</td>
<td>- strengthened the control and accountability of crown corporations</td>
</tr>
</tbody>
</table>
In the area of financial management and control, the Commission made a number of recommendations. On the planning side, they were designed to shift the emphasis in the Main Estimates from the nature of expenditures to their purpose, to permit a valid assessment of requests for resources and departmental performance. It would also allow Members of Parliament to form an objective judgment on the desirability of continuing or modifying specific programs in the public interest.

In 1969, the Government adopted the Planning, Programming, and Budgeting System (PPBS). This system was designed to focus attention on the outputs of programs rather than on inputs. Government managers were forced to ask themselves what they were trying to accomplish with, for example, travel expenses rather than worrying primarily about how much they were going to spend on travel. The adoption of PPBS led to a change in the format of the Estimates in 1971. In that year, the Estimates reported planned expenditures by government program and activity rather than just by standard object.

In addition, the Glassco Commission recommended that aspects of responsibility for financial control be decentralized. The Office of the Comptroller of the Treasury was abolished and pre-expenditure control responsibilities given to departments. Departments were to operate within common policy guidelines developed by the Treasury Board. Senior financial officers were to be appointed in each department. Departments were to be responsible for developing their own financial systems, and they were to adopt modern management reporting techniques.

**Financial Management and Control Study, 1974–76**

The Auditor General of Canada initiated a Financial Management and Control Study to assess both the adequacy of systems and controls in departments and agencies and whether additional responsibilities delegated to departments after the Glassco Commission Report were being properly discharged. In his 1975 and 1976 reports, the Auditor General expressed serious concerns about the adequacy of departmental systems and procedures for financial management and control. He concluded that financial management and financial control systems were substantially below acceptable standards of quality and effectiveness.

**The Royal Commission on Financial Management and Accountability, 1979**

The Royal Commission on Financial Management and Accountability (commonly referred to as the Lambert Commission) confirmed the
Auditor General's findings. It also identified a number of defects in government organization and processes. The Commission believed these had led to a breakdown in the accountability chain. The problems included a lack of effort to establish clearly defined objectives against which the performance of departments could be measured. Also, no process was in place to exact an accounting from departments, and financial and other information essential for measuring performance in relation to objectives was missing. A significant recommendation of the Lambert Commission was the annual preparation of a five-year fiscal plan. The Government adopted this recommendation and the Department of Finance now prepares such a document. The current fiscal plan provides a short-term overall financial framework within which detailed planning and requests for spending authority are prepared.

MAJOR INITIATIVES SINCE 1975

Table 2 shows when the major initiatives in financial management and control over the past 15 years were started. The following paragraphs elaborate on certain of these initiatives.

Policy and Expenditure Management System, 1979

In 1979, sluggish economic growth, growing inflation, and mounting public debt spurred the Government to make further reforms to help ensure that expenditures were put to the most efficient and effective use. A new budgetary system was introduced, known as the Policy and Expenditure Management System (PEMS).

Under PEMS, total government expenditures were divided into a number of spending "envelopes." In general terms, envelopes were

<table>
<thead>
<tr>
<th>Year</th>
<th>Initiative</th>
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<tbody>
<tr>
<td>1978</td>
<td>Office of the Comptroller General established</td>
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<tr>
<td>1979</td>
<td>Policy and Expenditure Management System (PEMS) introduced</td>
</tr>
<tr>
<td>1981</td>
<td>Program evaluation guidelines published</td>
</tr>
<tr>
<td>1981</td>
<td>Part III of the Estimates introduced as part of reform of the Estimates</td>
</tr>
<tr>
<td>1985</td>
<td>Cash management policies and directives issued</td>
</tr>
<tr>
<td>1986</td>
<td>A program called &quot;Increased Ministerial Authority and Accountability&quot; (IMAA) introduced</td>
</tr>
<tr>
<td>1989</td>
<td>Cabinet committees restructured and overall resource allocation process revised to help control spending and reduce debt and deficit; PEMS abandoned</td>
</tr>
</tbody>
</table>
functional displays of government activity. For example, envelopes were provided for social development, economic and regional development, defense, fiscal arrangements, services to government, external affairs and aid, Parliament, and public debt.

To operate PEMS, a Priorities and Planning Committee and four Policy Committees were created. Priorities and Planning determined the size of each envelope in consultation with the Minister of Finance and the President of the Treasury Board. The Policy Committees managed the envelopes within their established dollar limits. They also made decisions on what programs should be introduced, reduced, or eliminated within the general policy goals established by the Government.

Envelopes were to be created for five-year periods, and were to be updated annually in response to changes in economic conditions. The basic building block for resource allocation under PEMS was the Operational Plan Framework (OPF). OPFs were prepared for each program. They were designed to set out and relate objectives, planning elements, and expected results. They were based on the assumption that program objectives could be clearly identified and stated. By 1989, however, although aspects were retained, the PEMS system was essentially abandoned.

Part III of the Estimates, 1981

In a 1981 revision of the Estimates, the Government committed itself to providing both Parliament and the public at large with an entirely new type of information. Previously, Estimates information was solely about spending intentions. The revised Estimates were to be dual-purpose documents containing information on both planned expenditures and actual performance. They would enable planned and actual departmental performance to be reviewed by the same Standing Committee, and they would establish an information base both for assessing future intentions in light of past performance and for holding the Government accountable for its performance.

Increased Ministerial Authority and Accountability, 1986

In February 1986, the Treasury Board announced an evolutionary process intended to change the management philosophy and culture of the Public Service of Canada. This process is known as the Increased Ministerial Authority and Accountability (IMAA) initiative. Its objectives are to (a) provide ministers and senior managers with increased authority and flexibility to deal with changing circumstances and to manage resources; and (b) enhance their accountability.
for achievement of results and for compliance with Treasury Board
policies.

Under IMAA, the focus of the Treasury Board will shift away from a
concern for compliance with procedural rules to emphasize program
results and the achievement of government-wide policy objectives.
The Treasury Board will delegate more authority and simplify and
reduce detailed reporting requirements. This delegation will allow
departments more discretion to reallocate resources within and be­tween appropriations, provide increased departmental limits when
entering into contracts, provide authority to classify certain positions,
give greater flexibility in other personnel matters, and reduce or elim­
inate the need for submissions to the Treasury Board to obtain ap­
proval for administrative matters.

There are three key documents in IMAA. The first document is the
OPF, which, as explained above, is designed to provide a clear state­
ment of program objectives, planning elements, and expected results.
The second document is the Memorandum of Understanding (MOU),
generally a three-year agreement negotiated between the minister
and deputy minister of a department and the President and Secretary
of the Treasury Board. The MOU establishes the authorities and ac­
countabilities that will govern the relationship between the depart­
ment and the Treasury Board. The third document is the Annual
Management Report (AMR), an internal accountability report from a
department to the Treasury Board that describes the departmental
environment, contains deputy minister representations about perfor­
mance, and includes quantitative performance data required by the
MOU.

The AMR will be the basis for the deputy minister of the depart­
ment, the Secretary of the Treasury Board, and the Comptroller Gen­
eral to review performance and discuss issues of concern. A major
accountability review is to be undertaken by the Treasury Board in the
final year of the MOU. The review will focus on the achievement of
objectives and results as represented in the AMRs.

Cabinet Committees Restructured and Resource Allocation
Process Revised, 1989

On January 30, 1989, the Government announced a new Cabinet
decision-making system. Although details of the system are still be­
ing refined, it appears to signal the end of PEMS. Overall resource
allocation has been centralized under the Priorities and Planning
Committee—chaired by the Prime Minister—and the Treasury Board.
Policy Committees no longer have discretion to authorize expendi­
tures. They now deal with policy implications only. A new Expendi­
ture Review Committee, also chaired by the Prime Minister, is mandated to ensure that the Government's expenditures continue to be directed to its highest priorities, and that expenditure control continues to contribute to deficit reduction.

LOOKING TO THE FUTURE—RESTRAINT, 1989

On April 27, 1989, the Minister of Finance tabled his annual Budget in the House of Commons. A main concern of the Minister was the growth of the Government's public debt and the exploding cost of paying interest on that debt. Expenditure restraint and other measures to reduce debt and deficit will likely be a primary focus of the Government for some time to come.

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Budgetary Accounting in China

WANG SONG NIAN and TANG YUNWEI

Accounting for the public sector in the People’s Republic of China is termed budgetary accounting. It is designed to record, report, and supervise the implementation of the state budget and to provide information for budgetary control. China is a socialist country whose economy is characterized by public ownership. The budget system bears some unique features that have a significant impact on budgetary accounting. An understanding of the public finance and budget system is necessary before going into accounting issues.

PUBLIC FINANCE AND BUDGET SYSTEM

In China, the majority of business enterprises are owned by the state. The state acts both as a political power to levy taxes and as the owner of numerous business enterprises to claim profits. The dual function of the state complicates the public finance and budget system.

Unlike in western countries, public finance in China is more involved with social production and distribution of national income. That is, it involves directly the allocation of production factors and the distribution of the financial results of state-owned enterprises. Through the taxation and profit remittance system, the state gathers a large portion of national income (financial revenue) and then uses it for capital construction investment, appropriation of working capital, and a renovation fund for the state-owned enterprises, and for maintaining state functions in a planned manner (financial expenditure). On the other hand, finances for fixed assets and current assets of state-owned enterprises come from state appropriations.

1Reform of the income tax system is under way. In the past, all state-owned enterprises were provided with production inputs by the state, and profits were remitted to the state. This profit remittance system has been replaced by an income tax system under which the enterprises turn over the income tax on profit earned, while retaining profit after income tax to be used for different purposes.
The other part of financial resources comes from retained earnings that may, according to the new tax law, be used for special purposes such as expanding production, developing new products, and providing welfare. The remainder is financed from debt.

In addition to state-owned enterprises, collectively owned and privately owned enterprises are now allowed to develop in China. The relationship between the state and those enterprises is similar to that in western countries, that is, the state levies taxes on their net income. As for joint ventures with Chinese and foreign investment, the state not only levies taxes but also enjoys relevant portions of their profits.

Viewed from the perspective of the whole economy, the social products may be classified according to their final use into three categories of funds: compensation fund, consumption fund, and accumulated fund. Currently the major part of the accumulated fund and a small part of the compensation fund are realized through the distribution of public finance. The national income that is distributed through the state budget accounts for approximately one third, and for the other two thirds, a small part of the accumulated fund and a major part of the consumption fund (mainly personal consumption) are realized through the initial distribution taking place within the state-owned, collectively owned, and other kinds of enterprises.

STATE BUDGET AND OFF-BUDGETARY RESOURCES

The state budget is part of the public finances centrally handled by the state. It is an important tool by which the state effectively carries out its functions and distributes financial resources under its control. Furthermore, it serves as the basic financial plan within China’s comprehensive financial plan, and through it an endeavor is made to apply the country’s limited resources effectively to socialist construction.

The state budget comprises the receipts and allocations of budgetary resources. At present, the state budgetary receipts consist of seven categories.

- Receipts from enterprises. This category includes profits from enterprises to which the profit remittance system is still applicable; “contract fees” and “rents” from enterprises to which the contract responsibility system applies; and “adjustment taxes” from enterprises for their high level of profits.

- Income tax from state-owned enterprises. These receipts are actually a combination of income tax and profit claimed by the state.
• Obligatory contribution to the state fund for the development of energy and communication. This is a partial levy and an off-budgetary fund.
• Various types of taxes. This group includes tax on transactions (product tax, value-added tax, excise tax, tariff), on natural resources, for special purposes (construction tax, civic construction maintenance tax, etc.), utility tax (property tax, land utilization tax, etc.), and agricultural tax. These taxes yield more than income tax receipts and have become the primary source of budgetary receipts.
• Receipts from debt such as that from other countries, international agencies, and treasury bills.
• Special type of receipts such as pollution penalty charges.
• Other receipts.

The allocation of budgetary funds is directly related to implementing state policies, developing socialist constructions, and improving the people's lives materially and spiritually. Budgetary expenditures may be classified into capital construction appropriations, extra appropriations for current funds, expenditure on supporting agriculture, operating expenses in branches of industry, transportation, communication, and commerce, expenditures on social services, culture, education and science, state administration, and state reserves of physical assets.

Budgetary control is exercised through unified leadership and decentralized management, in keeping with the character of a planned economy. Unified central leadership and comprehensive planning are deemed necessary for managing the national economy in a balanced and planned way. However, the fact that China is a country with a vast territory and with different economic bases and natural endowments necessitates decentralized management at all levels of the budgetary structure and administrative divisions. Corresponding to the four levels of the state power structures and administrative divisions (that is, central government; provinces (autonomous regions and municipalities under the direct control of the central government); counties (cities, autonomous counties, and municipal districts); and townships (towns)), the state budget can be divided into two parts, central and local. The central budget includes the budgets of all central departments and the financial budgets of key enterprises under the direct control of the central government. The local budget (including provincial, city, and county budgets) consists of the budgets of local units and the financial budgets of local enterprises as well as summarized subordinate local budgets. Because the local budget incorporates the budgets of all local units and summarized subordi-
nate local budgets, it is called the "overall budget." In charge of drawing up and carrying out the overall budgets, financial administrations at all levels act as state budgetary units. Correspondingly, administrative and institutional units at different levels are responsible for the respective unit budgets.

Based on the public ownership of the means of production, the state budget of China has the following five characteristics:

- It is required to carry out the tasks and policies set up by the Chinese Communist Party and the state.
- It acquires and allocates budgetary resources according to a plan for the balanced development of the national economy.
- It accumulates the funds necessary for socialist construction through self-reliance, and at the same time it utilizes foreign capital as much as possible to enhance the capability of self-reliance.
- It applies the greater part of budgetary funds to socialist construction and to improve the people's material and spiritual life, reflecting the basic economic law of socialism.
- It adheres to the principle of keeping receipts and expenditures in balance, which is required by the comprehensive balance of the socialist national economy.

Another important part of the public financial system is off-budgetary funds, which are not collected and distributed through the state budget; instead, they are under the direct administration of local governments and units. Because of the varying economic developments in different areas and divisions, the state budget cannot take into account all their financial needs and related allocations. These resources are received and expended by the administrative units according to their needs. Off-budgetary funds are thus necessary supplements of the state budget. They include off-budgetary funds managed by local government, including various kinds of surtaxes; off-budgetary funds managed by administrative institutions, including various kinds of operating revenues; special item funds managed by enterprises and their supervisory units, including replacement and renovation funds, and overhaul funds; and various loans raised by the authorized institutions.

Off-budgetary funds have been increasing rapidly in recent years. In many provinces and cities, they have exceeded budgetary funds. Although not managed by the central government, they are nevertheless brought into the state plan. The state prescribes the definition, the criteria used in collection and expenditure, and the scope and purposes of such funds. Special measures are taken to prevent bud-
getary funds from transferring into off-budgetary funds. To that extent, off-budgetary resources are still the subject of budgetary accounting.

**BUDGETARY ACCOUNTING—AN OVERVIEW**

Budgetary accounting is deemed an integral part of budgetary control. Its structure therefore corresponds with budgetary structure. Following the structure of the state budget, accounting is also classified into overall budgetary accounting and unit budgetary accounting.

**An Outline of the Budgetary Accounting System**

Both the overall budgetary accounting system and the unit budgetary accounting system are centrally prescribed by the Ministry of Finance. The budgetary accounting system involves the following aspects:

- Tasks fulfilled by budgetary unit accounting;
- Accounting organizations and personnel;
- Account titles, accounting documents, account books, and their usage;
- Accounting for budgetary receipts and expenditure, and off-budget revenue and expenditure;
- Verification of physical assets;
- Accounting statements and their preparation;
- Auditing, its content and method;
- Procedures for turning over work to successors;
- Maintenance of accounting files.

**Structure of Budgetary Accounting**

Budgetary accounting is designed to account for movement of both budgetary and off-budgetary resources. Budgetary accounting comprises two aspects previously referred to: (a) overall budgetary accounting, which is conducted by the Ministry of Finance at the central level and by financial administrations at the local level; and (b) unit budgetary accounting or accounting for administrative and institutional units, which is implemented by individual units such as government agencies, judicial and related organs, universities, and scientific research institutes.

Overall budgetary accounting concentrates on the collection and the allocation of budgetary funds, whereas unit budgetary accounting is carried out to handle appropriations received and their use. Organizationally, overall budgetary accounting can be divided into three
Chart 1. Framework of Budgetary Unit Accounting
corresponding levels. They are (1) the Ministry of Finance at the central level; (2) bureaus of finance at the provincial level; and (3) departments of finance at the county level.

In addition, the following four categories of accounting can be considered, in a broad sense, as integral parts of overall budgetary accounting: (1) accounting for the national treasury administered by the People’s Bank of China; (2) accounting for capital construction appropriation used by the People’s Construction Bank of China; (3) accounting for agricultural fund appropriation used by the Agriculture Bank of China; and (4) accounting for tax resources used by tax authorities. These kinds of accounting must be used (in close cooperation with the overall budgetary accounting conducted by financial administrations at all levels) to record, report, and supervise comprehensively overall budgetary performance and result.

According to the structure of governmental institutions and the regulations for withdrawing and reimbursing budgetary funds, there are three kinds of administrative and institutional units at different levels that draw up the unit budget and carry out independent unit budgetary accounting, that is, top-authority level, second-level, and basic accounting units. Top-authority level accounting units draw and reimburse their budgetary funds from financial administrations at the same level; second-level accounting units are under the top-authority level accounting unit and have their own subordinate accounting units; and basic accounting units are independent accounting units at the lowest level responsible to a top-authority level or second-level accounting unit. All these units at the three different levels make use of budgetary accounting and have responsibility for funds under their charge. Chart 1 presents a framework of the budgetary accounting system.

### Functions of Budgetary Accounting

Units at all levels are obliged to carry out the state budget both effectively and efficiently, but since each level has different tasks, the contents of overall and unit budgetary accounting differ somewhat. In general, budgetary unit accounting performs three functions in recording, reporting, and supervising the acquisition, disposal, and balance of budgetary funds. In carrying out these functions due attention is to be paid to the following purposes of budgetary control.

First, to provide reliable data used in budgetary control. Budgetary accounting employs systematic methods to account for budgetary activities and to prepare financial statements so as to reflect the status of government finances. These data are used by different levels of government to analyze the developments in the execution of the budget, to find problems, and to take the necessary corrective measures.
Second, to observe financial discipline. The budgetary accounting units are responsible for carrying out financial policy and disciplines set up by the state. Through an examination of documents and accounts, physical inventory, and periodic checks to ascertain any non-compliance with the law, or the existence or emergence of waste and extravagance, these units are expected to safeguard the state assets.

Third, to secure budgetary revenues and expenditures. By participating in collecting revenues and in their spending, the budgetary accounting units reveal the gaps in the fulfillment of budgetary expectations. They enable the department responsible to supervise the utilization of budgetary funds.

Characteristics of Budgetary Accounting

Compared with business accounting, the characteristics of budgetary accounting can be summarized in terms of the following three aspects.

- More uniformity and wider coverage

To collect information on countrywide implementation of the state budget, it is necessary to have highly unified procedures, methods, and targets for budgetary accounting, even though different sectors and branches exist. The broad coverage of budgetary accounting is well reflected in its scope. Budgetary accounting deals not only with budgetary receipts and expenditures in the service sectors, it also involves profits, taxes and appropriations for capital construction, and sources of current funds for the production of materials.

- Cash basis accounting

By applying the cash basis, budgetary accounting is more helpful in determining and reconciling budgetary revenues, expenditures, and balances. It also facilitates the preparation of accounting statements and analysis of the impact of budgetary operations on the economy.

- Calculation of profit or loss

Generally speaking, budgetary accounting does not calculate profit or loss. Those units charging their products and services provided, however, are required to calculate profit and loss to enhance their economic effectiveness. The accounting procedures used may be somewhat simpler than those used in business accounting. In determining profit and loss for budgetary units, the accrual basis has to be adopted.
OVERALL BUDGETARY ACCOUNTING

Overall budgetary accounting is an important component of the system of public finance. It is designed to calculate, report, and supervise the execution of the state budget, and to promote its fulfillment. The basic tasks of overall budgetary accounting conducted by the Ministry of Finance and financial administration at all levels are

- To handle regularly such accounting events as budgetary revenue, national treasury deposit, budgetary appropriation, budgetary expenditure, current transaction budgetary circulation fund, and off-budget revenue and expenditure, and to organize periodic examinations of financial administrations, taxing authorities, and the national treasury. These tasks are to provide timely, reliable, and accurate financial information.
- To prepare and summarize ten-day, monthly, and quarterly accounting statements; to participate in reporting the performance of the state budget to financial administrations at higher levels and the People’s Government at the same level; to be in charge of carrying out and examining the final accounts for state budgetary units and administrative and institutional units.
- To supervise and encourage, in cooperation with the receiving agencies responsible for providing budgetary receipts, the task of timely and complete remittance; to help all units that receive budgetary appropriations to make reasonable and economical use of their budgetary funds; to arrange budgetary funds carefully and skillfully according to the seasonal nature of budgetary revenue and expenditure so as to resolve the contradictions between the potential of financial resources in the treasury and the need to use them to ensure that all funds for socialist construction are appropriated according to the budget.
- To assist the national treasury in receiving budgetary funds on time, allocating them among the different levels, and turning over the required portions to higher authorities; to assist in having functional departments within a financial administration provide the national treasury with plans, rules, and regulations concerning the implementation of the state budget.
- To formulate the overall and unit budgetary accounting systems and the detailed rules for enforcement according to state policies, laws, decrees, and regulations; to cooperate with the People’s Bank in drawing up national treasury regulations for enforcement.
- To guide and supervise unit budgetary accounting at the same level and at the lower level.
Overall budgetary accounting routinely records, reports, and supervises the receipts and allocations of budgetary funds on the basis of documents, accounts, and statements.

The original documents used in overall budgetary accounting can be classified into the following four formats: (1) daily reports and supporting documents concerning budgetary revenue obtained from the treasury, such as documents of returning budgetary revenue and notices of payment and correction; (2) documents of budgetary appropriations and transfer vouchers of receipts, including authorization for the bank to pay and the advice of remittance; (3) monthly statements of payment for capital construction from the People's Construction Bank of China; and (4) other documents in support of other accounting transactions.

To clarify the sources of different funds, the accounts of overall budgetary accounting are divided into two parts: budget and off-budget. Under the conditions of receipts/payments bookkeeping required by budgetary unit accounting, all accounts, whether in-budget or off-budget, must be classified into fund source, fund application, and fund balance. Table 1 shows these items.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Accounts</th>
<th>Receipt Side</th>
<th>Payment Side</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary fund</td>
<td>Sources and application of funds</td>
<td>Budgetary revenue</td>
<td>Appropriations received</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Subsidies received</td>
<td>Suspense deposit</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Budgetary expenditure</td>
<td>Appropriations given</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Suspense payment</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>Fund balance</td>
<td>Deposit in treasury</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Receipts and payments in transit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Off-budgetary fund</td>
<td>Sources and application of funds</td>
<td>Off-budgetary revenue</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Suspense deposit</td>
<td></td>
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<tr>
<td></td>
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<td>Off-budgetary appropriation</td>
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<tr>
<td></td>
<td></td>
<td>Off-budgetary expenditure</td>
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<tr>
<td></td>
<td></td>
<td>Suspense payment</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>Fund balance</td>
<td>Other deposit</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The relationship among the three sorts of accounts mentioned above can be stated in the following equation: the sum of the receipt-side balances of all fund source accounts less the sum of the payment-side balances of all fund application accounts equals the sum of the receipt-side balances of all fund balance accounts.

In view of this equation, both the budgetary and the off-budget funds should be in equilibrium.

According to the overall budgetary accounting system, four corresponding fund source accounts are usually set up to reflect budgetary receipts from different sources: budgetary receipts turned over to the national treasury; budgetary grants appropriated from financial administrations at a higher level; budgetary receipts from financial administrations at a lower level; and budgetary funds transferred from off-budget funds.

Because overall budgetary accounting does not involve the transaction of purchasing goods or paying cash, there are no such accounts as "fixed asset," "material," or "cash."

The overall budgetary accounting of financial administrations at all levels can check budgetary performance at any time through vouchers and accounts. However, to grasp, analyze, and assess budgetary performance during a certain period, a summary needs to be made on the basis of the prescribed target system and the routine accounting information that comprises the following three types of overall budgetary accounting statements: (a) a statement of final accounts for budgetary receipts and disbursements and a statement showing the status of budgetary funds, including a summary statement of final accounts for budgetary receipts and disbursements, a supporting schedule of final accounts for budgetary revenue, a supporting schedule of final accounts for budgetary disbursements, a statement showing different levels of final accounts for budgetary receipts and disbursements, and a statement showing the status of budgetary funds at the end of the year; (b) a statement of basic data showing such norms as organization and personnel spending standards and the operational achievements of administrative and institutional units; and (c) other supplementary statements prepared as explanatory material on the above-mentioned final accounting statements, whose contents depend on features of annual budgetary performance and requirements for analyzing final accounts.

**UNIT BUDGETARY ACCOUNTING**

Unit budgetary accounting is employed by administrative and institutional units to record, report, and supervise the performance and result of a unit budget. Administrative units refer to all authorities
that bear responsibility for managing state affairs, such as the Standing Committees of the People's Congress at all levels, the People's Government at all levels, judicial and procuratorial organs, political parties and groups, and people's communities. Institutional units are concerned with all organizations that are not engaged in the production and circulation of material goods but that are necessary for socialist construction, such as cultural establishments, institutions of education and scientific research, medical and health institutions, and units of economic construction.

Unit budgetary accounting plays an important role in unit budgetary control systems by carrying out the following basic tasks:

- To use budgetary appropriations reasonably and economically, according to the approved budget, and to organize operational revenues according to prescribed policies.
- To perform such routine jobs as calculating, record-keeping, checking, closing, and reporting, and to prepare accounting statements required by the unit budgetary accounting system.
- To carry out accounting supervision to safeguard state resources in accordance with state policies, laws, decrees, and regulations.
- To aid budgetary control, accountants must regularly evaluate and analyze the experience of budget execution and ascertaining why the budgetary units fail to fulfill their tasks.
- To draw up supplementary regulations and rules and to direct and supervise the accounting practices of subordinate units with the guidance of higher authorities and according to one's own needs.

Unit budgetary accounting can be classified further into three categories depending on the funds provided and the type of budgetary controls exercised. Units may be full budgetary units, differential budgetary units, or self-reliant budgetary units. The features of the accounting systems of these units are considered below.

**Accounting for Full Budgetary Units**

Under the pattern of full budgetary control, all revenues and expenditures of administrative and institutional units should be brought into the state budget, which means that their expenditures are completely covered by the state budgetary appropriations and their revenues (except off-budget revenues retained with the approval of the state) are completely turned over to the state. This approach is particularly suitable for administrative and institutional units that have
very few revenues of their own and that are dependent on state appropriations for such expenditures. Educational institutions, libraries, etc., belong to this category. Following the approach of overall budgetary accounting, unit budgetary accounting classifies all accounts in terms of sources, application, and balance. The balance equation in this respect is the same as shown in Table 1.

Budgetary units are required at the beginning of each quarter to make their quarterly plans on a monthly basis for the approved yearly budgets. After these plans are reviewed and approved, they will receive their appropriations through banks from financial administrations at the same level, or budgetary units at a higher level. Thus, no appropriations can be given without approved budgets.

Budgetary appropriation is one side of the fund movement, and disbursement, reflecting actual expenses, is the other side. Disbursements are used as a basis for assessing the performance of the unit budget and therefore need to be properly classified and charged to the correct account. Supplementing this are more detailed accounts. According to the current unit budgetary accounting system, full budgetary units can have such detailed expenses as wages, fringe benefits, employees’ welfare, retirement payments, stipends, general office expenses, equipment investment, repair charges, and operational expenses. Following the conventional principles involving scrutiny of the legality of transactions and the availability of funds, the system ascertains that payments are made after norms and spending standards have been verified.

Accounting for physical assets has its own features distinct from those of business accounting. Since there is no perceived need to calculate cost, unit budgetary accounting does not handle depreciation but only uses “fixed assets” and “fixed assets fund” to deal with the increase and decrease of fixed assets. Two kinds of conditions for consumable materials exist, however. Those institutions that consume a lot of materials maintain certain reserves to meet their needs. To account for these materials properly, it is necessary to establish the “materials” account charged at purchase and written off at use.

In the meantime, full unit budgetary accounting should cover also off-budget events to reflect the movements of both budgetary and off-budget funds. On the basis of routine accounting, different statements must be prepared, including one showing movements of unit budgetary funds, one showing the increase and decrease in appropriations, one showing the final accounting for appropriations used, a supporting schedule of current accounts, a statement of final accounting for off-budget revenues and expenditures, and a statement of basic data.
Accounting for Differential Budgetary Units

Adopting the pattern of differential budgetary control, budgetary units should compensate their expenditures with their own revenues. The differences between expenditure and revenue will be made up by a state budgetary appropriation if the former is larger than the latter, or turned over to the state if the former is smaller than the latter. This pattern can be adopted by those units that have regular revenues such as hospitals, theaters, and gymnasiums.

Three approaches to differential budgetary control are in use: (a) subsidies for specific items (such as wages, fringe benefits, and employees’ welfare) can be covered by subsidies appropriated, and other needs must be met by the budgetary units’ own revenues. At the end of the year, no additional subsidies are available, and any surplus revenues are retained for the units’ future use; (b) normal subsidies, that is, the yearly subsidies granted to differential budgetary units, are calculated according to specific norms, such as subsidies per hospital bed. Once the subsidies are approved, budgetary units will neither receive additional subsidies nor turn their surplus revenues over to the state, regardless of the deficit or surplus; and (c) the amounts of subsidies or surpluses to be turned over to the state are determined by financial administrations on the basis of the units’ expenditures and revenues. Once these determinations are made, the units are expected to remit or receive funds regardless of the final budgetary outcome of a surplus or deficit.

Accounting for Self-Reliant Units

Self-reliant units are those with regular and stable operational revenue, and usually a surplus will exist after meeting operational expenses. To encourage these units to enhance their effectiveness and operation, and to permit them to enjoy more autonomous power they are allowed to retain the remaining surplus to expand their operations. Aside from this, they are subject to the same control as full budgetary units. Examples of self-reliant units are some scientific research institutes and forestry operations.

In comparison with full budgetary unit accounting, accounting for the differential budgetary unit and the self-reliant unit have some distinctive characteristics. First, in these two kinds of units, all revenues are used to cover expenses. Hence, no distinction is made between budgetary and off-budgetary funds. Second, operational revenue and expense are specifically accounted for. Operational revenues are the fees received from the sale of their services and are the main source of receipts. Operational expense is the expenditure made to obtain operational revenue. Specific accounts—operational reve-
Current Issues in Budget and Budgetary Accounting

Reform of the economic structure is well under way in China. A highly centralized planned economy is gradually giving way to a planned commodity economy. Local governments are being given autonomous power to handle public finances. Different forms of ownership are allowed to develop while public ownership still prevails. Ownership is separated from management in state-owned enterprises. Enterprises tend to finance their activities from different sources. These and many other factors have a significant impact on the budgetary accounting system. Several issues have already emerged in this field: one such area is the contractual budget.

In recent years many local governments have signed contracts with financial administrations at a higher level, which has set the budgetary surplus that must be turned over by local governments. This procedure creates many accounting problems. Accountants are asked to participate in the negotiations determining the budgetary obligation that involves the estimation of budgetary revenues and expenses. The proportion by which the budgetary surplus is allocated, including the proportion that can be used as a bonus, must be determined in advance. The internal control system aimed at protecting the state assets has to be designed. Many principles of budgetary accounting originally applicable become subject to change.

Inflation accounting is another area. For a long time, China adhered to the policy of keeping budgetary receipts and expenditures in balance and favored a slight surplus. This policy has been changed somewhat as reform of the economic structure has proceeded to allow a deficit to emerge. As a result, significant budget deficits showed up in consecutive years. Debate is continuing among economists about the desirability of such financing. Some criticize it as the source of inflation and prefer a tight policy, while others hold that it helps the economy so long as it is within controllable limits. This continuing controversy has some impact on budgetary accounting, in particular in terms of adjusting to inflation.

A third area relates to the off-budgetary fund problem. Off-budgetary funds are not centrally handled but must be channeled through budgetary accounting. These funds, as noted earlier, are increasing rapidly and have well exceeded budgetary funds. Maintaining control of these funds is difficult and complex. Since these funds are managed by individual units, a strong tendency exists to stipulate that they be used for capital construction. Such construction
might have contributed to the overheating of the national economy. Experience shows that it is difficult to curb this trend. According to one of the surveys, a large part of the funds is not used efficiently. Many projects are duplicated, thereby contributing to a waste of scarce resources.

Budgetary funds that are prescribed for a special purpose are sometimes transferred into off-budgetary funds. Although budgetary accounting is required to report and supervise such lapses, it is difficult to do in practice. Government auditors are naturally concerned about the numerous cases of this type that they have uncovered. One of the steps taken recently in auditing to prevent the recurrence of such transfers is that the auditors are empowered to impose direct penalties and can confiscate budgetary funds unlawfully retained by the budgetary units. Although this step is welcome, it is not clear whether it is adequate: it seems that there is much that needs to be done in this regard.

Another area relates to the introduction of concepts and procedures of business accounting into budgetary accounting. The new budgetary accounting system effective January 1, 1989 includes a category dealing with “accounting for cost and expense.” Any budgetary unit that sells products or charges for their services is required to account for product costs and expenses. The accrued basis is usually adopted to replace the cash basis, depreciation is calculated on fixed assets, and inventory flow assumptions of different kinds are made. Profit is calculated and distributed according to a predetermined arrangement. Some techniques of management accounting have also been introduced.
India: Developments in Government Accounting and Financial Management

D. SWARUP

INTRODUCTION

The protective role and responsibilities of government have undergone a radical change in the last few decades. The emphasis has been progressively shifting from maintenance of law and order to developmental activities. Over the years, the growing involvement of the state in the provision of social services and welfare schemes and in public ownership of industrial, manufacturing, and trading activities has added to the burdens of the government in budgeting and financial management.

In India also, the role and tasks of the Government have undergone a transformation since independence. From a Government that was mainly interested in maintaining law and order and in providing raw materials for industrial activities in the United Kingdom and a ready market for its finished products, post-independence India has seen a burgeoning of welfare schemes and developmental activities for the alleviation of poverty.

Modernization of the system of financial administration in India has also gathered considerable momentum since independence in 1947. Designed by the British, the financial system was one of the capable instruments of British administration in this country. However, it was highly centralized, with excessive emphasis on rules and procedures, a concern for details dominated all stages of budgeting and financial

1In preparing this article, the author has drawn upon the information and analyses in various books on the subject, notably Indian Administration, by Asok Chanda (London: Allen & Unwin, 1958), Government Budgeting and Expenditure Controls, by A. Premchand (Washington: International Monetary Fund, 1983), and Financial Administration in India, by M.I.K. Thavaraj (New Delhi: S. Chand & Co., 1979).
control, the executive was not responsible for maintaining accounts, no worthwhile legislative control existed, and the role of audit was far from satisfactory. Excessive centralization, itemized control, and distrust were the hallmarks of the system of financial administration evolved under British rule.

Independence brought about a radical change in character and scope of the Government of India. The system of financial control was found wanting in dealing with the dynamic needs of planning and implementing the massive schemes and programs of economic and social development. Decentralization of responsibility and delegation of financial powers were the first major steps toward modernization of the system of financial administration. Cost-benefit analysis of projects, performance budgeting, accounting reforms, zero-based budgeting, inculcation of financial consciousness in the administrative departments, and changes in the nature, emphasis, and object of audit are the major developments that have taken place in recent years. Although these innovations were made haltingly and piecemeal, they are increasingly being welded into an integrated whole to modernize the system to meet the growing challenges of development administration. While India was greatly influenced by developments abroad, especially in the United Kingdom with regard to modern financial management, the efforts to change the inherited system of financial management that was not suitable for the new role of the Government of independent India in the context of development were organized internally. The main reforms included improved budget agencies, reorganized budget structures, and strengthened financial management capabilities in spending agencies. The emergence of planning in 1950 took care of the problems of expenditure planning.

FINANCIAL SYSTEM IN INDIA

The overall process of control over the financial administration in India is exercised through the legislature, executive, and audit.

Legislative control over the finances is exercised mainly in two stages: the first at the time of policymaking and the second in controlling the implementation of the policy. The legislature has control of the purse and determines the manner of raising the resources and the amount and manner in which the money so raised is spent. It specifies objects on which the money raised is spent and determines each year the amount to be spent on each of the various objects. This initial control is exercised when the annual budget or the annual financial statement showing the estimated receipts and proposed expenditures of the state administration for the financial year is presented. The second stage of control—the control over the implementation of the
policies—is to ensure that moneys voted by the legislature have been utilized for the purpose and in the manner that the legislature wanted. This control is exercised through parliamentary procedures and a system of committees.

The administration is engaged in carrying out the policies acceptable to the legislature. It is accountable to the legislature about how it has collected moneys as authorized by the legislature and how it has utilized them to implement the policies laid down by the legislature on the specified objects. The outstanding feature of a democracy is this accountability by the administration to the legislature. The administration also has to ensure that similar accountability is formulated by each authority subordinate to the one immediately above in the hierarchy.

The scope of the state audit encompasses fiscal accountability—which includes fiscal integrity, full disclosure, and compliance with applicable laws and regulations; managerial accountability—which is concerned with efficiency and economy in the use of public funds, property of personnel, and other resources; and program accountability—which is concerned with whether government programs and activities are achieving the objectives established for them with due regard to both costs and results.

**LEGISLATIVE PROCESS**

The system of financial control in India is modeled on the British pattern. The Constitution of 1950 created a Consolidated Fund to which all revenues received and all loans raised by the issue of treasury bills and all moneys received in repayment of loans have to be credited. The Constitution also created a Contingency Fund for meeting unforeseen expenditure pending subsequent authorization of the expenditure by Parliament. It also provided for a Public Account in which all transactions relating to debt, deposits, advances, and remittances are accounted for. On the analogy of the position obtaining in the United Kingdom, the Constitution of India also introduced a provision of a "Vote on Account," to enable Parliament to consider the estimates more carefully over an extended period. Under the system provided for in the Constitution, a statement of estimated annual receipts and expenditures is prepared by the Government and presented to Parliament. This annual financial statement is commonly known as the budget. The budget shows receipts and payments of the Government under three heads: Consolidated Fund, Contingency Fund, and Public Account. The budget comprises the Revenue Budget and the Capital Budget. The estimate relating to expenditure "charged" upon the Consolidated Fund is not submitted to the vote.
of Parliament though it is open for discussion in Parliament. The other expenditure is submitted to Parliament in the form of demands for grants on the recommendation of the President. A broad demand is proposed for each ministry/department. Each demand contains a statement of the total amount required and a statement of the detailed estimate under each demand divided into items. After the demands have been passed by the legislature, a bill is introduced to provide for the appropriation out of the Consolidated Fund. No money can be withdrawn from this Fund until this bill is passed by Parliament. The bill when passed becomes the Appropriation Act.

The Finance Bill containing the annual tax proposal is considered and passed by Parliament only after the demands for grants have been voted and the total expenditure is known, whereupon it enters the statute as the Finance Act.

The preparation of an annual financial statement—the budget for the approval of Parliament—is a constitutional obligation on the part of the executive. Parliament exercises full control over expenditure through this mechanism. Though executive ordinances can be used temporarily to raise resources, no lasting tax measure can be introduced by an ordinance. Similarly, no expenditure can be incurred by the executive except with the approval of Parliament. The President can, however, authorize the expenditure when the constitutional machinery fails or between two sessions of Parliament. But this authorization of expenditure has to be ratified in the next parliamentary session.

The budget estimates in India are on a cash basis, budgeting is gross, and the amounts voted lapse at the end of the financial year and cannot be utilized in the succeeding year.

The budgetary process generally comprises the following stages:

- Preparation of the budget;
- Consideration and adoption of the budget by Parliament;
- Execution of the proposals in the budget; and
- A postevaluation of achievement and performance.

The administrative departments have to frame their estimates of receipts and expenditures bearing in mind the general policy of the Government and the developmental schemes approved by the Planning Commission. These estimates are then sent to the Ministry of Finance, which consolidates all these proposals and estimates in the form of the budget.

While finalizing the budget proposals, the Ministry of Finance has to keep in view the amount of resources available and the acceptable levels of budgetary deficits. The next stage of the budgetary cycle is
its consideration and adoption by Parliament. Parliamentary discussion of the budgetary proposals affords an opportunity to members to review the working of the Government in general. The process of preparing the budget, discussing it in Parliament, and its subsequent approval can be considered an effective instrument of financial management of government activities.

In India, the expenditures voted by Parliament are immediately available to the spending departments and ministries. However, release of funds by the administrative ministries to the field formations and public sector undertakings is based on periodic profiles of expenditure projected by the spending agencies. This review is carried out with a view to controlling and monitoring expenditure. The spending agencies are mostly equipped with budget and planning units to undertake a periodic review to show the variations, budgetary lags, expenditure patterns, and relationship between physical and financial progress. Such periodic reviews are, however, performed routinely at the time of release of funds at specified intervals. Quarterly meetings are organized at which trends in expenditure vis-à-vis budget provision are reviewed, and midcourse adjustments are made. The Ministry of Finance also takes stock of expenditure trends against budgetary allocations in periodic meetings with financial advisers of various ministries. Economy in unplanned expenditure is emphasized to minimize the budgetary deficit. The postbudget evaluation is carried out through the operations of various parliamentary committees, such as the Public Accounts Committee, the Estimates Committee, and the Committee of Public Undertakings. While the Estimates Committee is charged with undertaking a detailed examination of budget estimates put forth by the Government in respect of each administrative department, the other two parliamentary committees examine the expenditures incurred by the executive to ensure that the moneys disbursed were available and applicable to the service to which they had been applied, that the expenditure conformed to the authority that governed it, and that rules of financial propriety and economy in expenditure were duly observed. These committees also check the aspects of efficiency with which a project or scheme has been implemented and whether its objectives were attained or not.

**ROLE OF AUDIT**

Audit forms an indispensable part of any financial system and is one of the important organs necessary to ensure the sound functioning of a parliamentary democracy. It is the main instrument to secure accountability of the executive to the legislature. Audit assists Parlia-
ment in exercising financial control over the executive to ensure that funds voted have been utilized with due regard to economy and efficiency for the purpose intended, and that the funds authorized to be raised through taxation and other measures have been assessed, calculated, and properly credited to the Government.

Envisaging an important and statutory role for audit, the Constitution installed the Comptroller and Auditor General of India as a high independent statutory authority. Audit of the accounts of the Union and of the States is a Union Subject. A unitary audit in a federal setup is designed to play a significant role in effective financial administration for the overall national interest. The Comptroller and Auditor General is the one dignitary to ascertain on behalf of the elected legislature that the expenses voted are not exceeded or varied, and that the money expended was legally available for and applicable to the purpose for which it was applied. The Constitution safeguards the independence of the Comptroller and Auditor General in a variety of ways. His duties, powers, and conditions of service have been set out in an Act of Parliament passed in 1971 under Article 149 of the Constitution.

Auditing methods, practices, and standards have changed considerably over the years. The support and encouragement of the Speaker of the lower House of Parliament and the Public Accounts Committee have been an important factor in the evolution of the audit. India is now moving more and more from the usual regularity and transactions audit to the economy, efficiency, and effectiveness audit because of the expanding programs in the context of our socioeconomic objectives. The emphasis is now on appraisal of performance of programs and projects as well as of the soundness of the system. The fundamental object of audit is to secure real value for the taxpayers’ money. To conduct all these audits, a variety of methodologies and techniques had to be developed, and in this field the Indian Audit Department has done important work. Recent innovations include a unified audit of scientific departments and institutions and a systems-based manpower audit. The Indian Audit Department is continuously updating auditing standards to keep pace with the international developments in this field. Great attention is devoted to training staff at all levels for quality upgrading and for coping with new audit areas.

To enable him to discharge these duties effectively, the Comptroller and Auditor General is empowered to

- inspect any office of the organizations subject to his audit;
- call for any books of accounts and other relevant documents that he requires during audit; and
- call for such information as he may require to prepare any account or report.
He is also responsible for compiling accounts of the states, except Goa. He was relieved of the responsibility of maintaining accounts of the Union Government in 1976 by an Act of Parliament, after the separate organization of the Controller General of Accounts under the Ministry of Finance was established.

The audit reports of the Comptroller and Auditor General on the accounts of the union/states are submitted by him to the President/Governor, who causes them to be laid before the Parliament/legislature. They are then remitted to the Public Accounts Committee, which examines them and makes recommendations to Parliament on the various issues involved. The process of public accountability is now complete.

**PRINCIPLES OF GOVERNMENT ACCOUNTING**

One of the distinctive features of the system of government accounts in India is the minute detail into which the financial transactions of the Government under receipts and payments are differentiated and classified.

**Principles of Classification**

The conventional pattern of classification was on organizational lines and consisted mainly of the listing of receipts according to various types of taxes and the statement of expenditures according to the department in which they occurred and its objects or grounds. With the phenomenal growth and diversity in government functions involving huge outlays, the necessity arose for a more meaningful classification of transactions for presentation of government operations in terms of functions, programs, and activities.

**Accounting Reform**

A team set up by the Government went into the question of accounting reform and made recommendations to reform the structure of budget and accounts. The important objectives to be achieved from these reforms were

- to have a uniform classification for the budget accounts and plan;
- to present the objectives and purposes of government expenditure clearly in terms of functions, programs, and activities;
- to bring together under the appropriate functional (major), program (minor), and activity (subhead) heads all expenditures on that function, program, scheme, or activity, irrespective of the organization administering it;
• to help the management with timely accounts data for monitoring any analysis of expenditure on program and activities and also to secure itemized control over expenditure; and
• to facilitate the introduction of performance budgeting.

The recommendations of this team were accepted by the Government, and the Comptroller and Auditor General, with the approval of the President, prescribed revised classification of government transactions, which were effective from 1974-75, by the Union, State, and Union Territory Governments.

From April 1, 1987, a revised coding pattern has been introduced that keeps in mind the emerging requirements and provides for computer-based financial information systems. In the revised pattern, a four-digit Arabic numerical code has been assigned to the major heads of accounts, followed by a two-digit code for the relevant submajor heads, and followed further by a three-digit code for the minor heads. The codification pattern for the major heads has been designed in such a way that the last three out of the four digits represent the same function in the four sections, namely, receipt heads (Revenue Section), expenditure heads (Revenue Section), expenditure heads (Capital Section), and "loans and advances," except in a few cases where more than one function has been grouped together as a submajor head under a single major head.

The advantages of a uniform system of classification for all stages of financial administration—preparation of the budget estimates, voting of demands, implementation, accounting review, and audit—cannot be overemphasized. Such a system improves public accountability by presenting a comprehensive picture of various governmental activities across sectors and also affords the Government an opportunity to review its own performance with reference to objectives of economic and social improvement.

Performance Budgeting

The streamlining of demands for grants and accounting heads to fit the needs of activities and program classification was necessary if performance budgeting was to be introduced. The demand for introducing performance budgeting was first made in the lower House of Parliament as early as 1954. It was followed up by the Estimates Committee, which recommended in its twentieth report on budgetary reforms (1959) that the performance-cum-program system of budgeting would be ideal for a proper appreciation of the schemes and outlays included in the budget, especially for large-scale developmental activities. It went on to say that the experiment toward introducing performance budgeting on a selective basis to supplement the
traditional budget should be expedited. These recommendations were repeated in 1959 and 1960 by the Estimates Committee.

However, no serious efforts were made to introduce performance budgeting until the Administrative Reforms Commission on Finance and Accounts recommended in 1968 that it be introduced in all departments and organizations that were directly responsible for implementing developmental projects and programs. The Administrative Reforms Commission stated:

Performance Budgeting which, in essence, is a technique for presenting government operations in terms of functions, programs, activities and projects, seeks among others, to achieve the following important objectives:

(a) to present more clearly purposes and objectives for which the funds are sought and to bring out the programs and accomplishments in financial and physical terms;
(b) to help a better understanding and better review of the budget by the Legislature;
(c) to improve the formulation of the budget and to facilitate the process of decision making at all levels of Government;
(d) to enhance the accountability of the management and at the same time to provide an additional tool to management control of financial operations; and
(e) to render performance audit more purposeful and effective.

It is nearly 20 years now since performance budgeting was first introduced. However, identification of norms and efficiency yardsticks on performance continue to pose problems. The performance budgets are still prepared only as supplementary documents to the main budget. It will take more time before the performance budget becomes a more effective tool of management in the Government.

Another important development in the field of financial management has been the introduction of the concept of zero-based budgeting. This form of comprehensive budget was first introduced in the United States in the Department of Agriculture. The introduction of this concept envisaged that "all programs will be reviewed from the ground up and not merely in terms of changes proposed for the budget year. . . . The fact that certain activities have been carried out for a number of years will not, per se, adequately justify their continuation. . . ."

The Government of India has not made any serious efforts to implement the system of zero-based budgeting. However, realizing the importance of this comprehensive form of budgeting in the context of rising deficits and the need to control expenditures, the Ministry of Finance in 1986 directed the major economic ministries to make use of this concept to some advantage. As of now, the concept of zero-based
budgeting, that is, de novo examination and scrutiny of all ongoing projects and programs with a view to adjusting priorities in the context of financial constraints, is informally used in the Ministry of Finance and the Planning Commission.

**SEPARATION OF AUDIT AND ACCOUNTS**

In the pre-independence era, the question of separation of audit and accounts was raised from time to time but could not be given serious consideration. In addition to the practical difficulties, there were problems of cost and manpower. Thus, except that accounts of the Defense Forces were always separated from audit, the setup of accounts and audit continued in other government departments until separation was introduced in the railways in 1925 as an experimental measure and adopted as a permanent arrangement in 1929.

After independence, the process of separation of audit and accounts proceeded gradually. From April 1951 partial departmentalization of accounts took place in the Department of Posts and Telegraphs. Similarly, in April 1955 the responsibility for making payments and maintaining accounts of the Food Rehabilitation and Supply Departments was transferred to the respective ministries. The transfer of accounts relating to payments of the Rajya Sabha and Lok Sabha Secretariats was also made with effect from October 1955. In 1968, the accounting functions in respect of the telecommunications branch were transferred.

It was only in 1976 that a major exercise of departmentalization of accounts covering all the ministries and departments of the Union Government was undertaken and completed in a phased manner, with the main objective of integrating accounts with the administrative ministries and departments. Under this scheme, accounts and finance form an integral part of overall management. Administrative ministries have been entrusted with the responsibility of arranging payments and timely compilation and rendering of accounts.

The salient features of the scheme are that the secretary to the ministry/department is the chief accounting authority and discharges this responsibility through and with the assistance of the integrated financial adviser of the ministry/department.

The integrated financial adviser is responsible for preparing the budget of the ministry/department and distributing budget allocations to the various wings, departments/ formations; arranging payments directly to the bodies, corporations, and authorities of grant-in-aid loans, etc., as may be sanctioned by the department; compiling and consolidating accounts of the ministry/department in accordance with the instructions issued by the central government and/or the
Comptroller and Auditor General and rendering the appropriation accounts; and introducing a system of management accounting suited to the functions and requirements of the ministry/department.

The payment and accounting functions of the ministry/department are discharged through departmental pay and accounts offices.

The payment as well as receipt transactions relating to the ministry/department and its attached and subordinate offices are transacted at the branches of the Reserve Bank of India and the State Bank of India, or its subsidiaries, or at specified branches of public sector banks accredited to the department without intervention of the Treasury.

CONTROLLER GENERAL OF ACCOUNTS

With the separation of audit and accounts at the union level, an organization headed by the Controller General of Accounts was created in the Department of Expenditure of the Ministry of Finance. It is entrusted with the responsibility of establishing and maintaining a technically sound departmentalized accounting system; laying down the form of accounts relating to the Union and State Governments; administering the rules relating to the custody of the Consolidated Fund, the Contingency Fund, and the Public Accounts of India; consolidating the monthly accounts of the Union Government from the monthly accounts prepared by the various central pay and accounts offices and the state accountants general/directors of audit; and preparing the annual accounts (commonly known as union government finance accounts) showing under the respective heads the annual receipts and disbursements for the Union Government and also summarized civil appropriation accounts, comparing the actual expenditure under various grants/appropriations with the grants voted/appropriations charged as specified in the schedules appended to the Appropriation Act passed by Parliament.

DELEGATION OF FINANCIAL POWERS

Allied with the concept of separation of audit and accounts was the question of devolution of greater financial powers to the administrative ministries. Prior to independence there was excessive concentration of authority in the Finance Department. The Estimates Committee of the first Lok Sabha, which examined the matter of financial administration, thought that the control of the Ministry of Finance was more rigid on minor items of expenditure and lax on major items. The Estimates Committee advocated that itemized control should be delegated to the various ministries and departments and the Ministry
of Finance should devote its attention to major proposals involving huge outlays.

A well-known authority on public administration, Paul H. Appleby, who studied the Indian administrative process, was also struck by the highly centralized character of the Indian financial system as well as the way in which the matters of detail were referred to the central agencies for concurrence even though the decisions on budgetary allocations had already been made. According to him, financial management could be more effective if the deployment of appropriated funds was left to the discretion of the spending agencies. The exercise of such judicious discretion, he thought, was conducive to a more effective and efficient discharge of responsibilities.

The first major step for delegation of enhanced financial powers to the administrative ministries was taken in 1958. It related mainly to sanctioning an expenditure up to a specified limit, and payment of grants and loans under certain conditions. The need for further delegation of powers continued to be felt by various parliamentary committees and by the administrative ministries. In 1961, therefore, the Government prepared a statement on measures for administrative improvements. This policy paper recommended that the existing system of financial control should be reorganized, financial responsibility should be devolved on the administrative ministries, and the control of the Ministry of Finance should be exercised through prebudget scrutiny, adequate reporting, random checks, etc. Thus, further financial delegations were made in 1962. It was envisaged that the administrative ministries would, in their turn, delegate administrative and financial powers to the heads of departments and other subordinate authorities. The delegation scheme of 1962 was reviewed in 1967, and a new scheme incorporating larger financial powers to the administrative ministries was introduced in October 1968. This scheme provided for greater delegation relating to the reappropriation of funds and also enhanced powers for creating managerial jobs required for public corporations. Again, in 1973, a comprehensive review of financial delegations was undertaken by the “Group of Ministers,” who addressed themselves to improving administrative performance. As a result of this review, the Group of Ministers recommended enhanced delegation of powers. These recommendations were accepted by the Government and implemented with effect from April 1975. The main features of the enhanced financial delegations include the power to redelegate to subordinate formations, the creation of posts up to a particular rank, and only prebudget scrutiny to be exercised by the Ministry of Finance. In 1988, administrative departments were given powers to sanction plan schemes up to Rs 20 crores and nonplan schemes up to Rs 5 crores (1 crore is equivalent to 10 million).
Exercise of Delegated Powers

There have, however, been problems in exercising the financial powers delegated to the administrative ministries from time to time. While delegating such powers, the Ministry of Finance had always laid down certain conditions under which these powers were to be exercised. Moreover, in the context of the need to control public expenditures, it had often issued orders for effecting economy in expenditure. Such instructions have somewhat restricted the exercise of delegated powers by the spending agencies. In fact, they created an ambience in which the officers are not always willing to accept responsibilities and routinely refer the cases to superior authorities. The Estimates Committee therefore had to recommend that the officers should understand that they will not be allowed to play safe and transfer their responsibilities to higher authorities but will have to take decisions on matters falling within their own jurisdiction.

SYSTEM OF FINANCIAL ADVICE

With the devolution of responsibility for internal financial management to the administrative ministries and commensurate delegation to them under a system of performance budgeting and management accounting, the role of the administrative ministries and the Ministry of Finance required a radical change. An important reform was accordingly made in 1975-76 with a view to forging closer links between planning and budgeting on the one hand and actual expenditure and performance on the other. Prior to this period there was a system of internal financial advisers in various ministries. They were required to help and advise administrative departments in their budgetary, financial, and related work and to assist them in a proper exercise of control over expenditure. Outside the delegated powers, the proposals had to be referred to the Ministry of Finance. The scheme of integrated financial advisers from 1975 onward is an improvement over the earlier schemes of devolution of financial powers and gives more powers to ministries and also makes them accountable for effective financial management. This scheme has enabled a more direct role to be played by the finance branch in each department in developmental programs.

FEDERAL FINANCE

Another aspect of managing financial resources is the institutional arrangement by which tax revenues are allocated to the federal units—states. India is a union of states. A large number of economic,
social, and developmental functions and responsibilities have been assigned to the states by the Constitution. With regard to raising resources, the Constitution has assigned the power of taxation either to the union or to the states, whichever is in the better position to levy and collect them, thereby attempting to avoid overlapping of tax jurisdiction. The principles according to which taxes raised are to be distributed among the union and the states have been made the responsibility of the Finance Commission, which is constituted by the President under the provisions of the Constitution. It is the duty of the Finance Commission to make recommendations regarding the distribution of income tax and the union excise duties between the union and the states and the allocation of the states’ share among them and also regarding the principles that should govern the grants made under Article 275 of the Constitution to cover the gap between the estimated revenue and expenditure. The net proceeds of any tax or duty, that is, the actual proceeds reduced by the cost of collection, are ascertained and certified by the Comptroller and Auditor General of India under a constitutional provision.

Over the years, the main channel for giving grants to the states in meeting outlays on developmental schemes and programs has, however, been the Planning Commission, by taking recourse to the constitutional provision in Article 282. The relative importance of the Finance Commission has therefore diminished according to many financial analysts, as the major responsibility for grants-in-aid to the state governments has been taken over by the Planning Commission. This action has led to some criticism by some state governments.
Government Accounting in Poland

ALICJA JARUGA

INTRODUCTION

As is generally recognized, state budgets arose earliest in countries that had developed parliamentary traditions. Parliaments initially decided about state revenues and later about their allocation. In Poland the first budgetary records in the form of financial registers have been traced to the fourteenth century. Since that time Polish kings have been asking Parliament for permission to levy new taxes on citizens. However, the first Polish budget was passed by Parliament in 1768, and the Constitution of 1792 established a right for Parliament to approve revenues and public expenditures. This Constitution and the principles of the Polish budget subsequently served as a model for many European countries.

After regaining independence (1918–39), public finance and the State Treasury were reorganized based on the model of parliamentary democracies. However, after the Second World War, and in the context of the introduction of a centrally planned economic system, considerable change took place in the state finance system. The state budget, together with the central plan, began to play the role of regulating the economy. It was and still is not only a plan of state revenue and expenditures with its usual functions, but it also constitutes a substitute for the market in the redistribution of financial resources between profit-yielding and nonremunerative industries. The Government operates here as a super manager. The institution of the State Treasury disappeared; the accumulation and distribution of financial resources is effected in an irreclaimable form by the state budget and in a repayable form by state banks. Similarly, local gov-

1A reform of the budget and accounting systems is now being undertaken in Poland. This paper depicts the systems as they were operating in 1989.
ernment budgets are replenished to a great extent from the central budget.

It was not until the end of the 1980s with the political and economic reforms aimed at democratization, decentralization, commercialization, and autonomy that there was a change in this situation. As part of these reforms, enterprises were made responsible for their own management, and the state budget deficits were financed by the central bank. Similarly, autonomy was provided to the municipal governments with rights to levy taxes and the like. The role and functions of the state are in transition.

INSTITUTIONS AND THEIR ROLES

In Poland, where state ownership dominates, the budgetary system is inextricably bound up with the economic activity of the state. The budget is broadly understood as the set of socioeconomic relationships involved in the accumulation and redistribution of state finances (Kaleta, 1985). The budgetary system consists of rules and procedures for budgetary receipts; rules and procedures for budgetary expenditures; budgetary planning; budgetary accounting and financial reporting; and budgetary control, which can also be called "auditing."

Local budgets are incorporated into the state budget, which facilitates the planned redistribution of national income among the provinces.

The distribution of tax revenues and other payments is as follows (Budgetary Act, 1984):

- The state budget comprises income taxes from state-owned enterprises; turnover taxes from state-owned enterprises; customs duties; social insurance; and payroll taxes and others.
- The local budget comprises real property taxes; estate duties; turnover taxes and income taxes from private, legal, and local entities; enterprises’ taxes; participation in central budget revenues; and general subventions and specific subventions from the central budget and others.

The Polish budgetary system and financial planning were developed within a comprehensive legal framework. The main roles of the central agencies are as follows:

- Parliament and Local People’s Council: Promulgation of the budget; control of budgetary implementation; review of periodic accounting statements; and discharge of the functions of the executive.
• The Supreme Chamber of Inspection: This organization is responsible for the audit of government transactions and reports on budgetary management to Parliament.

• The Council of Ministries: As the main executive arm of the Government, it is responsible for the following tasks in the area of financial management: prepares and submits a draft of the state budget to Parliament; defines rules of budgetary resources utilization; and generally supervises budget administration.

• Ministry of Finance (including the Supreme Inspectorate of Finance Control): Drafts budgetary policies and presents them to the Council of Ministries; manages the central budget implementation; organizes supervision over local budget performance; submits periodic reports on budgetary performance to Parliament; prepares statements on state budget performance for the Council of Ministries; formulates tax system rules; and standardizes financial planning and financial policy through the issuance of norms, which regulate preparation of budgetary drafts and utilization of budgetary resources; classification of budgetary receipts and expenditures; and accounting, financial reporting, and auditing.

• State administrative bodies supervised by the Ministry of Finance: The Financial Office deals with assessment and collection of taxes and other budgetary receipts, tax control, and penal cases, while the Treasury Chamber is responsible for planning, control, and disposition of central budgetary subsidies for enterprises and verification of annual financial statements of nationalized enterprises in coordination with state-authorized accountants, tax supervision, and Financial Office supervision.

• Local authorities have the following budgetary bodies: departments of finance of provincial or municipal authorities (which work under the overall supervision of the People’s Councils), formulate drafts of local budgets, and exercise control over local budget implementation.

• Financial departments of budgetary units and entities that are managed by chief accountants with responsibility for formulating plans of receipts and expenditures and maintaining records and reports to inform about budgetary compliance.

All spending ministries have their own budgetary departments. This description would be incomplete if no mention were made of the National Bank of Poland, which fully and exclusively provides cash service to the central budget and local budgets, and therefore has a major role in the process of control over budgetary compliance (Weralski and others, 1982).
In principle, the state seeks to balance its budget, but since the late 1970s it has been borrowing from the National Bank of Poland to finance its expenditures.

Budgets cover one year, and the fiscal year is the same as the calendar year. The following principles underlie their construction (Pirozynski and Winter, 1961):

- Equilibrium: they should be balanced;
- Coverage: they must be comprehensive and should include outlays; they should also follow the “gross budgeting method.” However, the “net budgeting method” is permitted at the level of budgetary units and entities;
- Unity: the national budget plan must include all receipts and outlays, including local government budgets;
- Clarity and specialty: strict criteria for the classification of receipts and outlays are to be followed;
- Anticipation: the budget law governing the annual budget must be passed before the beginning of the financial year;
- Reality: valuation of needs should be adjusted for inflation;
- Openness: the budget law must be published and parliamentary debates should be carried out openly;
- Economy: not only concepts of economy but also standards and norms of expenditures should underlie budget preparation and implementation.

In addition, other considerations stem from a system of nationalized means of production and central planning. First, there is an obligation of budgetary compliance with five-year national plans and the financial balances of the state, and second, there is the principle of democratic centralism, which requires the state budget to incorporate the receipts and outlays of the local governments, and, to the extent that local expenditures are higher than their receipts, they receive subventions from the central budget. The organizational relationships are illustrated in Chart 1. The observance of this principle, however, has not been without its difficulties in that a gap exists between the local needs and the centrally redistributed financial resources. Application of the incremental budgeting method may have repeated and compounded the errors even more (Hofstede, 1978, 1981).

In a socialist state, the state budget encompasses far more aspects of the economy than under capitalism, for it must finance not only administration, defense, and expanding social services, but also the basic investments required to implement the long-term, national physical construction plans. Through the budget, the Government provides part of the investment funds required to expand urban
housing facilities to meet the housing needs of the entire urban population and to subsidize urban housing to keep rents down to about one fifth to one tenth of the workers’ income.

Through the budget, the state assumes control of insurance and pension schemes under an integrated national social security program to provide uniform and equitable benefits for all.

Another feature of the Polish state budget is subsidies for consumer goods and services whose prices are set below unit production costs. They are four times the expenditures for science and education and more than twice as much as the outlays of the capital budget in the 1989 state budget. In addition, subventions provided to state-owned enterprises are over 10 percent of all their receipts.

It is almost a truism that in a centrally planned economy the use of the state budget to implement its financial distribution and redistribution tends to be considerable (Jaruga, 1988a). A more general observation, however, is that the greater the centralization of planning and control, the greater would be the degree of redistribution of finance through the state budget, which provides a substitute for the market mechanism, and in turn puts greater emphasis on the uniformity of all classes of accounting. To the extent that there is greater reliance on market mechanisms, the degree of redistribution of resources in the
economy by the state budget is likely to be smaller, and greater emphasis is put on accounting information for decision making and efficiency measurement (Jaruga, 1988b).

Owing to the compulsions of central planning, the whole economy is dichotomized into the spheres of "material production," which is also called the productive sphere, and "nonmaterial production," which is called the nonproductive sphere. It is assumed that only enterprises in the sphere of material production supply goods and services that create the national income, as, for example, industry, construction, agriculture, transportation, trade, municipal services, and film and publishing houses.

The nonmaterial sphere consists of institutions and units rendering services to individual citizens (for example, health, social welfare, and education) and the general public (for example, science, state administration, justice, national defense, internal security, finance, and insurance). This sphere includes budgetary units, budgetary entities, auxiliary holdings, and special resources.

Budgetary units are units of the state whose receipts and expenditures are fully financed by the state budget. Typical examples are state administrative bodies, hospitals, schools, and museums. Their services are free of charge. The mechanism for financing is an appropriation of credits within the General Budgetary Fund to the budgetary units. This fund is held at the National Bank of Poland. Unexpired credits at the end of the fiscal year are lost to the General Budgetary Fund.

Budgetary entities render public services on a break-even basis. They are accountable only for their financial results. If there is underspending against the annual appropriations, the unused resources can be carried forward into the next year. Budgetary entities, as well as budgetary units, do not depreciate fixed assets and do not pay taxes. They include nursery schools, clubs, and sports centers.

Auxiliary holdings are economic activities undertaken by budgetary units but financially separated. Typical examples are workshops attached to schools, and small farms attached to agricultural schools. They act as small enterprises, charge depreciation, and cover their costs from sales of goods and services. They can retain profit in the form of earmarked funds and are able to obtain bank loans. They belong to the productive sphere.

The category known as special resources covers, for example, broadcasting and television, and food supplied to schoolchildren (Cewe, 1978). These special resources are expected to be self-financing. Subsequent surpluses are paid over to the associated budgetary units.
State-owned enterprises in the material sphere are divided into three groups (Jaruga, 1988b): profit oriented; infrastructure and strategic; and public utility and municipal.

The first group is expected to be oriented to market signals, self-financing, autonomous, and self-governed. The second group encompasses infrastructure industries, such as fuel and power generation, coal mining, public transportation, and telecommunication, whose main objective is to provide products and services as effectively as possible. They are organized in obligatory unions and operate under mandatory prices, often set below cost, the so-called social prices.

The three groups of nationalized enterprises are distinguished primarily by the role that market mechanisms play in their functioning and development. An extension of this approach is that whereas the second and the third groups cannot go bankrupt because they are subsidized from the state budget or local budget, the first group can. Nationalized enterprises, mainly the first group, are allowed to enter joint ventures in the form of limited liability companies and joint-stock corporations and to create mixed-capital companies in the form of limited liability companies.

All budget-supported units are covered by budgetary accounting, whereas a system of enterprise accounting is followed for nationalized enterprises. (Following the analogy of nationalized industries in the United Kingdom (Jones and Pendlebury, 1984), one could include them in public sector accounting. The phrase “government” accounting is unknown in Poland.) Both types of accounting are uniform and follow the same general principles of accounting and the general plan of accounts. There are different types of plans of accounts and some of the basic concepts are different as well. The Ministry of Finance is entitled to regulate public sector accounting. Auditing is carried out mainly by state-authorized accountants for nationalized enterprises, and by the auditors of the highest chamber of inspection for budgetary units.

Recently, as a result of developments in democratization and decentralization, economic freedom, equality of all business units, and competition, a trend has emerged to enhance economic effectiveness and efficiency in both spheres. The way to do that is through more commercialization, the extension of market prices to some social services, and the shifting of some activities to the material production sphere. As far as social and public services are measurable and could be sold, financial results would provide measures of performance. Hence, the state or local government could practice budgetary control, using only the bottom-line approach, and these organizations
would replace budgetary accounting by more developed enterprise accounting and cost accounting.

Because of the requirements of the national accounting system all accounting entities have to follow the distinction between the two spheres, although where the line between the productive and the nonproductive activity should be drawn remains an open question.

On the other hand, even the nationalized enterprises were unable to be accountable in the long run. One-year performance evaluation and the incentives approach made them "budgetary entities." Capital investment funds were mainly centralized, and profitability was equalized by state budget subsidies. Therefore, state-owned enterprises were not fully adaptive organizations nor were they real commercial accounting entities but were rather a sort of governmental accounting entity (Lueder, 1989). Since January 1989, this situation has changed. State-owned enterprises have become autonomous and have started to be commercial accounting entities. They are supposed to pay dividends to the Treasury for a newly created Foundation Fund. They pay taxes, but they cannot decide about their future financial position and long-run strategy.

Structure of Accounting System

Budgetary accounting is defined as the quantification of budgetary outcomes in money terms, and its purpose is to ensure compliance with the accumulation, redistribution, and spending objectives of the national budget (Buszym, 1980). The budget system, including the capital budget and capital investment appraisal, both in the literature and in practice is understood as a part of finance, economics, and planning. Hence, budgetary accounting is limited to monitoring and reporting performance against the budget, following the budget law, the financial system, and the uniform principles of accounting and reporting specified by the Ministry of Finance, for example, the Typical Plan of Accounts for Budgetary Units (1988), a book of 283 pages.

Budgetary accounting maintains a strict separation of funds for different purposes. In the accounting system budgetary classification is as indicated below:

- **Part:** organizational entities (e.g., Ministry of Finance)
- **Sections:** a branch of services (e.g., health protection)
- **Chapters:** budgetary units within a given section
- **Line:** type of receipts and outlays
- **Paragraphs:** receipts by source (e.g., income tax outlay); receipts by purpose (e.g., wages and benefits)
- **Items:** separation of receipts and outlays in a given budgetary entity or earmarked fund
In addition to the normal spending of the ministries, separate funds are established for specific important needs such as an environmental protection fund; a science and technical development fund; a health protection fund; an agricultural development fund; and a housing fund.

The cash basis is used in budgetary units accounting, and a limited accrual basis in budgetary entities. Fixed assets are not realizable. Therefore, the equity measurement concept has not been applied. It has been made possible in nationalized enterprises since 1989, after forty years of a centralized, command economy. Cost accounting in budgetary units is relatively underdeveloped. No distinction is drawn between variable and fixed costs, and the concept of cost centers is not employed.

Capital investment appraisal is covered by central planning and is an integral part of national economic policy, outside the realities of the accounting system. The accounting function is only to monitor capital spending against the plan budget. Many budgetary units do not have legally separated organizations—for a group of schools, there is only one reporting entity, for example.

Budgetary accounting has been based on the double-entry system since the early fifties. Nevertheless, budgetary accounting has been treated as a bookkeeping, and a formalized system. Owing to relatively high inflation rates, unified adjustment procedures have taken place, based on the estimates of changes in general purchasing power.

There is no integrated electronic data processing system in the budgetary sphere yet. This branch of accounting has not been developed as a tool of financial control and accountability to the electorate or for formulating financial policy. Budgetary accounting is also not a part of the curriculum. The accountants in budgetary institutions are paid relatively less than in the state-owned enterprises, or in the newly developing private sector firms.

**Fiscal Reporting**

The form, contents, and frequency of financial reports are determined by the Central Statistical Office with some support from the Ministry of Finance. In principle, these reports are used for the fiscal policies and planning of the Ministry of Finance; control by the National Bank of Poland; financial management by spending ministries; audit by the Supreme Chamber of Inspection; financial management by local governments and managers of budgetary units; and the consolidated financial report for approval by the electorate.

The reports, which are prepared semiannually or annually, include
a statement of budgetary receipts; a statement of budgetary expenditures; a statement of inventories, receivables, and payables; a statement of performance against budgetary coefficients; a statement of budgeted and actual salaries and wages; a balance sheet; and a statement of off-budget receipts and expenditures.

The balance sheets are intended only to be reports of the closing ledger balances. Budgetary reporting, as well as financial reporting as a whole, emphasizes external users. This external, statistical emphasis is often at the expense of internal users and internal management.

Accounting and financial reporting are the financial tools of overall state control of a centrally planned economy. State control takes the form of control by each spending ministry over its budgetary units and especially the Ministry of Finance and its subordinate fiscal and inspection institution, the Supreme Chamber of Inspection. In the budgetary units the emphasis is on control of the financial and economic inputs. The outputs, which are often difficult to measure, are mainly under the control of the relevant professionals, for example, school inspectors. The criteria for the auditors' examinations are legal compliance, reliability, the existence of comprehensive records, economy, and effectiveness (Cewe, 1978). On the revenue side, the auditors and even the state-authorized accountants determine whether taxes and other charges have been collected in compliance with the law. On the expenditure side, they determine whether expenditures have been made in accordance with the budget, the applicable law, and other regulations. Budgetary discipline is so strict that there are serious consequences, for both individuals and organizations, when budgets are not executed in accordance with budget law. Sanctions can take the form of monetary penalties.

The structure of the reports used permits the aggregation of expenditure for the National Accounts System. Funds and expenditures are reclassified by tasks and programs.

The resource allocation in the budgetary process is based on incremental negotiations between the Ministry of Finance and the budgetary departments of the spending ministries. The spending ministries negotiate in the same way with their subordinate budgetary units. Expenditures are roughly estimated for the new fiscal year, since they have been based on the previous year’s budget figures with some minor adjustments. Budgeting is mainly based on rules and limits being sent as guidance to local governments and is based on the real results for the early part of a year.

In conclusion, budgetary accounting and reporting has been under the traditional, legally oriented, financial control of the Ministry of Finance and, during the last few years, of Parliament. Public managers use it mainly for compliance with financial rules. The recent
transition to a pluralistic political system and civic society will require a new budget law and a more sophisticated and flexible accounting system. The state superstructure will be replaced by democratic institutions. In addition, efforts will be needed to educate the public on the importance of sound financial reporting by the Government, which Morton Egol (1980) emphasized in a broader context. It is even more important in the current economic context of Poland.

**Major Problems and Recent Efforts**

As has been emphasized before, the budget is at the very heart of a centrally planned economy. Real coordination of the budget with the so-called financial balance did not occur until the 1980s. Integration of the budget and the financial plan has been reached during the last two years. The formulation of the costs of debt and investment appraisal is involved.

Financial management is also not developed in practice. For many years public accountability has not really existed. Investment decisions have been political ones. Studies on the costs and benefits of alternative ways of achieving policy goals have been quite rare. They were carried out by the Planning Commission, which has been recently downgraded to a Planning Department, with an agenda mainly limited to methodological aspects.

Under these circumstances, budgetary accounting in practice is confined to the first stage of development defined by Dean (1980) as "regularity and control." On the other hand, budgetary accounting and macrostatistics are highly integrated.

Financial reports of the budgetary institutions are not yet available to the public. However, it is expected that deeper democratization and orientation to market mechanisms will be followed by more public accountability, requiring more elaborate accounting and auditing.

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Government Accounting in Sweden

GERT JÖNSSON

FROM VERIFICATION TO CONTROL

In central government, as in other sectors, accounting has a multipurpose role. Accounting is a means of checking that funds are used for the appropriate purpose and do not “disappear” owing to inadvertent or deliberate mismanagement. Proper accounting also supplies information that can be used when allocating resources, planning the use of resources, and increasing efficiency. When a business enterprise or government agency grows, this growth tends to increase the importance of accounting as a source of information for strategic decision making and production control as opposed to its monitoring role. This development is very noticeable in central government today, because the impending reform of the budget process will require greater control and analysis of central government activities.

For many years, in fact starting in the mid-1950s, the public sector has grown rapidly in Sweden. This growth is due to an almost constant high rate of growth in the country’s economy, which has provided a basis for extensive social reforms. The social insurance system, which is a government responsibility, has been extended to include health insurance, retirement pensions, parents’ insurance, and partial pensions. Investments have been made in education and research. The Government has also pursued a very active and costly labor market policy, which has made it possible to keep unemployment down to a minimum throughout practically the entire postwar period. Many other reforms have also been implemented. Since the mid-1950s, public expenditure’s share of gross domestic product has risen from 30 percent to over 60 percent. Central government has to a great extent concentrated on implementing these reforms. Control has basically focused on the distribution of the increasing inflow of tax revenue to finance the reforms.

This situation changed around the middle of the 1970s. The rate of
growth slowed down to such an extent as to preclude the possibility of further reforms. A period of large deficits in the current account balance and the government budget followed. Although the economic situation has in recent years improved considerably in both industry and the public sector, with upward profit trends, increases in real salaries, and a balanced budget, there is today a political consensus that the public sector must not be allowed to expand anymore. At the same time, the Government faces great expectations for investments in the future. There has been a notable increase in the last few years in demands for more efficient utilization of resources and a re-examination of the role of central government. There is increasing interest in results in this sector to justify the rising costs. In a word, the interest has shifted from input to output. This development in turn focuses attention on the importance of informative accounting as never before. This paper deals primarily with this change of paradigm and the greater demands now being made on central government accounting and financial management.

**UNIQUE ORGANIZATION**

Central government in Sweden is organized on a model that is in many respects unique. This model is of some interest in this connection, and I will therefore give a brief description of it. Public administration is the responsibility of the Government, the municipalities, and the county councils. The municipalities are primarily responsible for school education, child care, and care of the elderly, social welfare services, etc. The county councils have overall responsibility for the public health service, among other things. The Government is responsible for the remaining sectors. The political bodies in charge of government at these three levels are elected in direct general elections. All three have the right to levy taxes. Tax collection, including that of the municipalities and county councils, is a central government responsibility. To a certain extent the limits of the activities of the municipalities and county councils are set by the Government, that is, by legislation and a system of government grants to many of the activities in question.

I will now turn to the question of accounting and financial management at the central government level, but there are many similarities here with the municipalities and the county councils. Sweden has a parliamentary system of government in the accepted sense. However, the Government exercises its power in a way that is far from usual. Basically, ministers make no decisions on their own; all decisions are collective decisions made by the Government. Government decisions are prepared by the Cabinet Office, which in its turn is
divided into a number of ministries. These ministries differ, however, from those in other countries in that they have small staffs, usually about 100-150, and their funds cover only their own administration. The real bodies of central government are a large number of agencies at the central, regional, and local levels. These agencies are responsible for activities within their special field. The nature and extent of these activities and spheres of responsibility vary greatly from one agency to another. There are some agencies with small staffs and a narrow range of responsibilities, while others have staffs running into tens of thousands, with responsibilities ranging over such complex areas as social insurance, labor market policy, taxation, the police, and the environment. The Government exercises control over these agencies mainly by means of written directives, but it has no right to make decisions on individual matters that come within the ambit of the agencies. All in all, about 330 government agencies are responsible for their own accounting and prepare their own annual accounts. This type of organization means that central government has long been divided into "profit centers," often with a qualified management in charge of accounting and financial management.

SOME CHARACTERISTICS OF ACCOUNTING AND FINANCIAL MANAGEMENT

Decentralized Responsibility

A fundamental feature of central government in Sweden is that the individual agencies are responsible for their own accounting and financial management. The Government stipulates the basic rules, additions to which are made by the Swedish National Audit Bureau (RRV). To a large extent, the National Audit Bureau supplies agencies with methods and systems in these areas, but the agencies are responsible to the Government alone. They must, for example, assume full responsibility for any shortcomings in their accounting. Ultimately, it is the responsibility of the head of each agency to ensure that accounting and financial management are carried out in accordance with existing rules.

Uniform Systems of Rules

Despite great differences in their scope, type of production, and sphere of activity, most government agencies are subject to more or less uniform rules with respect to accounting and financial management. The basic guidelines for planning and budgeting are contained in a budget handbook, while the most important requirements re-
Regarding day-to-day accounting and annual accounts are to be found in a special accounting ordinance.

Budget Handbook

A budget handbook containing regulations and advice on the planning and budgeting work of the agencies has been available since the end of the 1970s. It describes the procedures relating to the applications for appropriations that are submitted to the Government on September 1 each year, with details of resource requirements for the fiscal year starting on July 1 of the following year. These applications play an important part in the Government's preparation of the Budget Bill, which is presented to Parliament in January. The rules provided in the handbook formulate the basic formal requirements as regards the agencies' budget proposals, economic overview, long-term assessments, and results analysis. In addition to the formal requirements, the handbook contains advice and recommendations concerning methods of preparing the documents on the basis of which the Government makes its decisions. It also gives details of the rules applying to utilization of the funds placed at the agencies' disposal. Since the applications contain estimates, assessments, and requests relating to all the agency's activities (administration, transfer payments, and investments), they give a complete picture of the agency's judgments concerning the activities that are accounted for in the Government's budget.

Accounting Ordinance

The previous rather complex system of rules relating to accounting in central government was replaced, at the end of the 1970s, by the accounting ordinance, which was issued by the Government with implementing regulations from the National Audit Bureau. This ordinance defines the agencies' statutory obligation to keep accounting records, to record transactions continuously, to prepare annual accounts, and to value assets and liabilities. The provisions of the ordinance are basically the same as those applying to the private sector. As far as possible, the same terminology has also been used. The main difference is that the government agencies must submit information to the National Audit Bureau's department for accounting. Nor are agencies required to submit regular reports of claims and liabilities to the same extent as in the private sector, which also applies to their obligation to account for tangible assets. The rules relating to valuation are also slightly different. The ordinance contains a number of basic stipulations:
• All agencies are obliged to keep accounting records, and accounting must be carried out in accordance with generally accepted accounting principles. This means that accounting is to be complete, correct, and comparable with the previous year's accounts, and relevant with respect to the need for economic information;
• All economic transactions must be recorded as they take place in chronological and systematic order;
• The year's accounting must be concluded with the annual accounts. For it to be possible to use the accounts as decision data, the information must be divided into the agency's various activities or organizational units and must apply to the current year. The agency must also account for the various sources of financing. It is worth mentioning in this context that there are many other sources besides appropriations from the budget—for example, revenue from sales, contributions from other agencies, and reserve funds.

Other Rules

Apart from the rules mentioned above, there are several statutes of general application containing provisions relating to particular aspects of financial management in government agencies. For example, there are rules applying to payments to and from the Government, the purchasing of goods and services, sales of state property, and activities financed by fees and charges. In addition, the Government issues each year general directives to agencies as a complement to the budget handbook. These directives outline the economic frame of reference for the year's budget process and special formal requirements concerning the documentation to be submitted by agencies in their applications for appropriations.

Central Accounting Functions

Supervising the agencies' accounting, issuing the necessary implementing regulations and advice, as well as auditing the accounts of government agencies are all the responsibility of the National Audit Bureau, which is itself a central agency responsible to the Government. In addition to auditing the accounts and the management of each agency, the Bureau is responsible for the monthly and annual aggregate accounting of the entire central government administration. It also makes forecasts of trends in government revenue and expenditure. Furthermore, it administers the general central government accounting system and the general payments system, as well as developing accounting principles and methods and systems for financial management for the government agencies.
System S

Ever since the end of the 1960s, the National Audit Bureau has provided a general computerized accounting system, System S, which is currently used by all government agencies with the exception of the public enterprises (the Post Office Administration, the Telecommunications Administration, the Swedish State Railways, etc.), and a few of the larger administrations with special requirements. The defense agencies use a system of their own, but it has a great deal in common with System S and is technically integrated with it. Over 300 agencies that submit their own annual accounts, as well as several hundred authorities reporting to the major central agencies, use the system for their day-to-day accounting. The agencies that do not use System S submit accounting records produced by their own accounting systems to the Bureau as documentation for the aggregate accounts. System S is based on the rules established by the Government and the Bureau for the agencies' accounting, which naturally makes it easier for the agencies to apply these rules. It contains procedures for the current recording of transactions, payments and reconciliations, management accounting, annual accounts, and aggregate accounting at the national level. The fact that agencies can use preliminary and follow-up systems as a complement to System S and can also access data via computer terminals allows them to keep accounting data up to date and readily available. There is also scope for processing data locally and for combining accounting information with other information for follow-up and control purposes.

CREDIT GUARANTEES

Some government agencies are authorized to issue credit guarantees to the public for loans on the open credit market. Such guarantees may, for example, relate to regional, industrial, and agricultural policy. The National Audit Bureau has a central data system to account for credit guarantees, and this system can be accessed by personal computers at the agencies that are connected to the system. The Bureau collects information from this system and submits it to the Government several times a year.

Coordinated Payments System

Payments to and from the Government are channeled through a uniform payments system. Regardless of whether the payments concern tax collection, suppliers' invoices, or the payment of benefits to families with children and to pensioners, they are coordinated in a central account at the Bank of Sweden every day. Incoming and out-
going payments are primarily made through the postal giro service and other postal payment services. Clearance between the postal giro service and the central account takes place automatically. The payments system is also integrated with System S, which means that incoming payments generate accounting documentation in the system. In the same way, expense items in System S can automatically generate payments via the postal giro service. The payments system has recently undergone extensive technical modification to enhance its efficiency and security. The new payments system also promotes better cash management in central government resulting from the possibility of automatic interest calculations.

A Single Budget

A system with an operating budget and a financial budget for central government was introduced in the 1930s. The intention was to allow all changes in the state’s net assets to be accounted for openly in the financial budget, which was in principle to be financed by borrowing. Current expenditure was to be paid for out of the operating budget, which was to be financed by taxes. The operating budget would show a surplus or a deficit depending on the economic situation. In time, this budget philosophy changed. The distinction between a budget financed by borrowing and one financed by taxes was not maintained, and the decisions made by Parliament and the Government on the extent to which central government could be financed by borrowing were no longer made according to the original principles, but according to economic principles. And the account given of the state’s net assets in the financial budget was no longer accurate. There was thus no longer any justification for the division into two budgets. Therefore a budget reform was carried out in 1980, which resulted, among other things, in the fusion of the operating and financial budgets into one budget.

Budget Items

The income side of the budget comprises about 200 items, grouped under five main headings: taxes, revenue from government activities, income from property sold, repayment of loans, and calculated income. Tax revenue represents about 90 percent of total budget income. The agencies that collect taxes on behalf of the state also account for the revenue under the appropriate income heading. The expenditure side of the budget is organized on more traditional lines. It includes about 800 appropriations grouped by ministries. In addition to these appropriations, there is an appropriation for Parliament and its agencies, one for interest on the national debt, and one for
contingencies. When Parliament has taken its decisions on the appropriations the Government normally delegates the right to disposal of them to the agencies concerned, which are subsequently responsible for accounting for the use to which the appropriations are put.

Weaknesses and Strengths

Accounting and financial management in public administration are mostly well structured and well organized in Sweden. There is a high level of reliability as far as monitoring is concerned. The rules are also relatively easy to grasp. But in spite of this, problems do exist. In particular, society's demands on central government in the future will probably necessitate further development and, in certain respects, new thinking in these areas. To put the Government's development ambitions in perspective, it is necessary to outline some of the advantages and problems connected with accounting and financial management in central government in Sweden.

Accounting Rules

As has already been mentioned, several major systems of rules exist with general application to accounting and financial management in central government. This situation is of course an advantage in one way. With a common set of rules, all those involved know, or at least ought to know, what to do. There is, however, a risk that the system may become inflexible and sometimes unnecessarily complicated. If the rules are formulated in too general terms, there is, moreover, always a risk of noncompliance: that is, a tendency to stretch rules to the limit, since those involved may consider, rightly or wrongly, that generalized regulations are designed for activities other than their own. The regulations in the budget handbook, the accounting ordinance, and other rules applying to these matters provide a structural base and also allow comparisons between different areas. The information submitted by agencies in their applications for appropriations, their current recording of transactions, and their annual accounts can be coordinated. On the other hand, the general nature of the rules also tends to lead to all agencies being "lumped together" regardless of size, economic importance, or type of activity. The result may often be that sometimes the information given is unnecessarily detailed, while at others it is insufficient.

Support Systems

The use of the same basic accounting system by the majority of agencies has many advantages. It is also a great advantage that few
systems are designed specifically for the use of a single agency and that all systems are computerized. The systems can be adapted to the rules in force in central government, and it is relatively simple to aggregate accounting information. Large systems are also more likely to be cost effective, particularly since the cost of system maintenance, system development, and training can be shared by many users. One problem is that many users find all-purpose systems are too inflexible for the growing demands on accounting information as decision data. Furthermore, the trend in central government in Sweden is toward greater variety with respect to organization, control philosophies, follow-up methods, and financing. This increases the need for support systems that can be controlled individually and integrated into other computerized routines used at an agency.

Channeling payments to and from the Government through a uniform payments system generally has great advantages from the point of view of security and checks. It usually also provides good opportunities for coordinated, active cash management. To a certain extent the system limits the opportunities for individual agencies to exploit freely the competition in the payments market, owing to the priority given by the Government to the overall economy and security of payments procedures in preference to short-term profits for individual agencies. As regards other aspects of financial management (planning and budgeting, for example), not many support systems are especially adapted to central government. Such systems are therefore only used to a limited extent. Most agencies simply do not have the capacity or the necessary knowledge of the market to benefit from advanced support systems.

Analysis and Evaluation of Results

In many countries interest is increasingly focused, in both the public and the private sectors, on the bottom line. Sometimes there is a tendency in corporations to concentrate too much on short-term profits to the detriment of long-term development. There is a parallel to this attitude in the central government sector also. It is not unusual for more attention to be paid to the question of whether costs have exceeded the predetermined limits than to the achievement of the desired results. Experiments involving management by objectives and program budgeting have been carried out in Sweden, as in many other countries, but they have not been an unqualified success. An important reason why analysis and evaluation of results have not become regular activities within the framework of the budget process is the lack of appropriate methods and systems for measurement of performance. Apart from accounting, there are few routines and sys-
tems for the collection and processing of the supplementary information that is necessary to allow analysis of performance, productivity, and effectiveness.

**SHORTCOMINGS IN ASSET ACCOUNTING**

Attention has been drawn in recent years, by Parliament among others, to the lack of asset accounting. In an effort to meet the need for this information, the National Audit Bureau has in the last few years prepared so-called annual accounts for the Government, which means that a national balance sheet is drawn up with the addition of certain fixed assets. These annual accounts are a statistical product based partly on the collection of information separate from the accounting system. The accounting ordinance discharges most agencies from the obligation to account in full for such assets in their annual accounts. Some agencies administer substantial assets, and some of them have a commercial attitude to this administration. New forms of control with decentralized responsibility and authority are being considered. There is a need for better accounting, which includes the cost of utilizing assets and not merely the value of purchases. New sources of financing are appearing. All these factors have led to a need for improved asset accounting in central government.

**Money Is Free**

Most agencies finance their activities entirely from their budget appropriations. After they have been granted the right of disposal of these funds, it makes no difference to them if they make use of them immediately or at a later date. They have no incentive, for example, to delay payments for the sake of earning interest. If an agency is engaged in some commercial activity, and therefore has other sources of income apart from its appropriations from the budget, this may lead to non-interest-bearing funds being mixed with interest-bearing funds, which may be detrimental to the Treasury as a whole. The cost of financing is not usually paid for by the individual agency. There is therefore often no incentive for good cash management at this level.

**Controllers and Auditing**

Central government administration in which the individual administrative units have a large amount of responsibility of their own and extensive authority, together with the relatively well-organized general system of rules and efficient, uniform support systems for financial management, have made it possible to place the main responsibility for accounting and financial management on the agencies
themselves. This has also reduced the need for large central control and support units. The central accounting, financial management, and auditing functions are excellent, but are somewhat small. As the activities of government agencies become more complex and the requirements as regards resource management and results analysis are stepped up, the greater becomes the need for both control and support. Rapid technical development also increases this need. Accounting becomes more complicated, and an example is the examination of internal control in new computer systems. It also becomes more difficult for agencies to make appropriate choices of financial administration support systems, which leads to a rising demand for support from central bodies like the National Audit Bureau. The more stringent demands on resource management and results analysis also increase the need for a central perspective on accounting and financial management. The biggest gains in rationalization, effectiveness, and efficiency are often to be sought in intersectoral coordination and greater integration between activities and systems relating to planning, budgeting, accounting, analysis, and cash management—which increases the need for controllers at both the central and the local levels.

Renewal of Central Government

Since the beginning of the 1980s, the need for a radical reappraisal and renewal of central government has been increasingly discussed. A number of measures have already been initiated. These measures have been motivated by the size of the public sector and the very heavy tax burden, particularly if compared with that of other countries. At the same time, there are obviously large unsatisfied needs that can only be met by the public sector: for example, the growing proportion of pensioners requires increased government expenditure on pensions, medical care, and care of the elderly. The picture is expected to change in other areas too. These factors increase the need for effectiveness, efficiency, and rationalization in central government. Methods of control and analysis must be improved. The Government has recently presented a major program aimed at upgrading the budget process and improving control. The proposed measures are mainly concerned with financial management and accounting. I will here concentrate on rules, methods, and systems for financial management and accounting, but it must be borne in mind that the ultimate purpose of these measures is to promote a renewed central government so as to enable it better to fulfill the public’s need of the services provided by the public sector. A broad majority in Parliament has approved the Government’s proposals. As will be seen from the
following, a number of features in the program are designed to rectify some of the shortcomings and solve the problems that have been mentioned above.

A New Budget Process

An essential element of the Government’s program is a new budget process. It is proposed that once every three years all agencies will prepare an in-depth report and analysis of their activities and the results achieved. Basically, this analysis will deal with all aspects of their activities, regardless of whether they deal with consumption, transfer payments, or investments. The agencies will be divided into three groups, so that the activities of roughly one third of all agencies are examined each year according to a rolling three-year schedule. The Government will issue separate directives defining what the report from each individual agency is to cover. When it has examined the reports, the Government will move that Parliament establish the orientation of each agency for the next three-year period in conjunction with its decision on an appropriation to the agency for the next budget year. Financial planning limits will also be determined for the two subsequent budget years. The idea behind this new budget process, which has been tested in a rather large-scale pilot scheme, is to create more scope for analysis and for priority decisions than is possible with the short time available within the framework of the present budget process, thus enabling agencies to produce data that can be used to review activities and to increase effectiveness and efficiency. Greater demands will be made on agencies when it comes to reporting on the results they have achieved and preparing data for priority decisions by Parliament and the Government. The aim is to allow a thorough examination of the activities of each agency and of its need for public funds, instead of the present marginal examination of budgets.

A very important element in the new budget process is that all agencies, irrespective of where they are in the three-year cycle, must submit a special result report and preliminary annual accounts to the Government every year. This report will provide concise and intelligible information on costs, ratios, and productivity trends. This annual report requires a great deal more of agencies than the present accounting procedures, since it broadens the scope of accounting from purely economic factors to include also the agency’s performance. It is envisaged that the auditors will also examine the performance report and submit their findings to the Government. Obviously, the report will deal primarily with performance and cost trends. A thorough analysis of the effects of an agency’s activities will be performed
in conjunction with the in-depth report submitted every three years. After Parliament and the Government have established the orientation, the anticipated results, and the financial limits of an agency for the following three-year period, the agency will, in principle, have and utilize production factors in the most efficient and effective manner possible to achieve the goals established. As already indicated, Swedish Government agencies have great freedom from the outset by virtue of their independence, but the aim is to reduce further the detailed control of their activities by Parliament and the Government.

Technical Changes

The new budget process will make it necessary to formulate systems of rules, methods, and support systems.

General appropriations with debits and credits

To increase flexibility in agencies' use of the resources allocated to them, the new budget process will make funds available in the form of general appropriations with allocation of debits and credits. This process will allow agencies to transfer cash between annual budget limits. In other words, they will be able to save money one year for later use, or use some of the three-year appropriation in advance of the designated budget year. The excess money spent one year will then automatically be deducted from the following year's budget. An agency will thus be able to utilize an appropriation credit, which will allow longer-term planning of resource consumption. It will be able to save during one or more budget years to make a later investment, for example, in new technology, or, vice versa, it will be able to make such an investment at the start of the period to rationalize its administration and make it cheaper.

Financial management systems

More demanding accounting requirements will oblige agencies to acquire better financial management systems. Both the all-purpose accounting system, System S, and the independent systems used by some agencies basically lack the capability to record and process any but purely financial transactions. The new requirements will necessitate improvement of the ordinary accounting systems, as well as development within the agencies of systems for performance reporting. The work in progress at the National Audit Bureau on a new general model for central government accounting is crucial in this connection. This model is based on information science, and one of its basic elements is a system for classifying accounting information that is
neutral in relation to the information that needs to be processed. It will be possible to analyze different aspects of accounting information, for example, by resource type, by organizational criteria, and by function. Analysis of expenditure will be coordinated with other requirements and not, as hitherto, given priority. The intention is to test a data base model that allows the user to extract and analyze accounting data more flexibly than most existing accounting systems. When this model has been developed it will first be tested on some accounting systems being designed for individual agencies. The intention is then to use it as a basis for the general accounting system to be used in the 1990s.

Analysis and evaluation

As a result of the need for more detailed analysis, methods of analysis and evaluation must be improved and made suitable for general use. This work will be based on uniform concepts of analysis and evaluation, which will be applied to performance and results. Analysis of performance means recording and reporting production in relatively simple terms, such as quantity and unit costs—in other words, information that is to be reported in the annual result reports. Evaluation of results obviously involves a more advanced type of analysis, and this evaluation may be the most important element of the in-depth analysis submitted by agencies every three years. A large number of different methods of analysis and evaluation have been tried. One of the main objectives of the work being carried out in this area in Sweden is to define the appropriateness of these methods for different purposes, to give examples of how they can be used, and thus to provide central government bodies with concrete guidance on their choice of methods and aids. This information must be disseminated at all levels of central government administration.

Budget handbook

A start has been made on formulating rules, guidelines, and recommendations for the new budget process. This process calls for greater awareness of the objectives involved, of appropriate methods, and of the new formal requirements. The information must also be passed on to a larger target group. The new budget process requires cooperation from the agency line organizations. The new requirements are such that they can no longer be adequately handled by the agencies’ financial administration departments. A completely new budget handbook must therefore be prepared.
DEVELOPMENT OF ACCOUNTING SYSTEMS

The new budget process calls for new support systems for financial management. Great efforts are being made to make the present accounting systems more flexible, up-to-date, and accessible.

Cash Management

A great deal has been done to improve cash management in central government. These efforts have been necessary above all because the Government and Parliament have taken a decision to change the payment dates of pensions, grants to municipalities, etc. In most cases legislation has had to be amended. Government agencies have, however, shown little interest in cash management apart from the transactions that are subject to detailed statutory regulation. The reason for this is that they have not had any economic incentive to do so. The system of payments recently introduced is designed so that the postal giro accounts system will fulfill both the individual and the central agencies’ need for information about payments. This makes it possible to coordinate the day-to-day inflow and outflow of cash to and from an agency to meet the payment data requirements both of the agency and of the central bodies. In the long term this system will offer better opportunities than the previous one of following cash flows on a continual basis. It may also form the basis of a system under which appropriations carry interest. In such a system a normal payment profile could be calculated for each agency, and an improvement on this profile would yield an interest profit, that is, the appropriation would be increased. Such a system may have some drawbacks, such as the risk of agencies devoting too much energy to saving instead of concentrating on their legitimate activities. It is, however, a very interesting idea, and a study of the matter has been initiated.

Accounting in Agencies Financed by Fees and Charges

As I mentioned before, some agencies finance part or all of their activities by fees and charges for their services. A review of the complex rules relating to such activities is in progress. At present agencies do not have much scope for making investments to increase efficiency. Major investments in new technology and in enhancement of skills are subject to detailed examination by the Government and Parliament. A new type of financing has now been proposed that will give agencies greater responsibility and greater freedom with regard to purchasing equipment and investing in staff training. The solution
may be a credit institution that will grant loans to agencies on the same terms as bank loans. As noted earlier, some shortcomings exist in the accounting of assets in central government, which pose a problem particularly for agencies that finance part of their activities by fees and charges for their services. By and large, it should be possible to solve this problem by introducing a new accounting model, by reviewing the above-mentioned rules governing activities financed by this means, and by the new facility for financing investments. In the long term, the requirements concerning assets accounting in the central government may have to be increased. Measures to improve assets accounting at the agency level will naturally benefit the aggregate level also.

SUMMARY AND CONCLUSIONS

Accounting and financial management in the Swedish central government administration has developed gradually over the last few decades. The changes have not been the result of sweeping reforms, but have taken place step by step. Today’s development is largely the result of trends that go back as far as the 1960s, such as the desire of Parliament and the Government to make rational priorities on the basis of decision data that are of better quality and the tendency to give agencies greater freedom to make their own decisions on how to achieve their goals. Many technical improvements in financial management and accounting have resulted over the years. While development has not been rapid, it has had the advantage of allowing agencies to adjust to change without making serious mistakes. On the whole, central government in Sweden today has rules, methods, and systems that satisfy the basic requirements of effective financial management and fair accounting. The reason for the Government’s initiation of a large-scale program to improve control and analysis of central government activities is that the present budget process and financial systems are not considered adequate to cope with the more stringent rules governing resource allocation and the demand for more effective utilization of resources that will be needed in the future. A radical reform of the budget process and of financial management and accounting is therefore essential.

Although the Government’s program constitutes a coherent reform package, changes are to take place step by step. The program also basically represents a continuation and a refinement of the trends that have dominated these areas for a long time. The novelty of the program consists mainly in the emphasis given to the requirement that all central government activities must produce results, that is, agencies must themselves be able to show that the resources allocated to
them are used in such a way as to achieve the desired effects. As pointed out in the introduction, the special organizational structure of central government in Sweden, according to which agencies implement the decisions of Parliament and the Government with much independent responsibility and authority, creates clearly identifiable result centers. This situation in itself should promote result-oriented activities in central government in general. A significant difference between the reform program initiated now and earlier changes lies in the general approach to change. The Government stresses that the changes require broad participation from those who work at the various levels of central government. The reform must therefore be supported by intensive briefing and training programs. The work must proceed gradually, with continuous adjustment to realities and a large measure of pragmatism. Central government ranges over a large, diversified, and complex field. There is a risk that excessive standardization would be detrimental to credibility and expediency. What are needed are solutions that can be used flexibly in activities that vary greatly as to scope, type of production, and financing. The Government also stresses the need for new thinking in the ministries. The need to enhance the skills required for analysis and evaluation must be recognized, especially in the policymaking bodies. The Government is therefore planning to allocate considerable resources to central management of the reform and to the dissemination of information, training, and support to ministries and agencies. The prospects for successful implementation are therefore good. The fact that public finance is in better shape than it has been for a long time—a large budget deficit has now given way to a surplus—may also encourage all those involved to try out new ideas and new technologies.
Turkish Government Accounting and Financial Management System

TURAN S. KIVANÇ

In the early years of the Turkish Republic, which became an independent state on October 29, 1923, its budgeting and accounting procedures were based on the system inherited from the Ottoman Empire.

The first reform of government budgeting was made in 1923 in the new constitution by reformulating the budget within the principles of a parliamentary democracy. As a part of this effort, the budget classification was restructured on an organizational and line-item basis. In 1927, Parliament approved the General Accounting Law, which contained the principles and general rules of budgeting, accounting, fiscal reporting, and auditing, and was considered an important benchmark of the system. Government accounting procedures were covered by two regulations, which were prepared by the Ministry of Finance. In the 1930s, the legal framework was completed concurrently with the new laws for state purchases, payment of allowances, and the maintenance of the personnel cadre. The Ministry of Finance was also designated as the core agency in the financial management area.

The State Planning Organization (SPO) was established in 1960 and opened a new era by introducing the concept of planned socioeconomic development based on a five-year plan and annual implementation programs for capital projects. Also in the 1960s, a high-level Planning Council, under the jurisdiction of the Prime Minister and comprising the Ministers of Finance, Trade, and Industry and representatives of the Ministry of Finance, the SPO, and the central bank, was established to formulate and execute economic policy. A new approach was introduced by the Government, which required the SPO to provide "visas" for the spending agencies' capital expenditure estimates before transmitting the agencies' budget proposals to the Ministry of Finance. The SPO and the central bank were added to the list of core agencies.
In government budgeting, a key reform was made with the introduction of a program budgeting system in 1973. After being tested for four years in several ministries under a U.S. Agency for International Development technical assistance program, a version of the program budgeting classification, including a new standard object code, was implemented. The necessary amendments to the General Accounting Law were made in the Budget Act of 1973, and a new personnel system was also established.1

In 1977, an attempt was made, under an International Monetary Fund technical assistance program, to improve government accounting.2 A model for improvement was proposed but not implemented for various reasons. The Accounting Improvement Project Group later proposed a new approach, but it was not implemented either.3

The most recent institutional change was made in 1983, and the Ministries of Finance and Customs were merged (hereafter referred to as the Finance Ministry). The General Directorate of Treasury and the Secretariat of International Economic Cooperation were transferred from the Finance Ministry and were reorganized as the Undersecretariat for Treasury and Foreign Trade (UTFT), under the Prime Minister’s Office.

In government accounting, some improvements in the structure of accounts, books, forms, and statements were finally made in 1987 by amending the government accounting regulations.4

INSTITUTIONS AND THEIR ROLES

The Turkish public sector is divided into three institutional groups.

Central Government

This group comprises two categories: (a) general budget agencies, which include 31 agencies in the legislative (1), judicial (4), and executive (26) branches of the Republic (in fiscal year 1988); and (b) annexed budget agencies, which include 31 universities and 10 general directorates (such as highways, water affairs, environment, forestry, and sports).

4Devlet Muhasebesi Genel Yönetmeligiinde Ek ve Degisiklikler Yapilmasina dair Yönetmelik (Government Accounting General Regulation, as amended), No. 127011-10/1 (Ankara, January 2, 1987).
Although the state budget comprises the estimates of the above-mentioned general and annexed budget agencies, there are at least four more categories in this group. The relationships between the general and annexed budget agencies and the following agencies are reflected in the central government’s annual budget as transfer payments, but all are dealt with outside the central government’s accounting system.

- Revolving funds, which include more than 1,500 departmental enterprises (such as hospitals, corrective institutions, state farms, state forestry and monopoly enterprises, and technical schools);³
- Autonomous budgets, which include so-called independent organizations (such as the Turkish radio and television, central bank, press and advertisement organization, national productivity center, and Turkish standards institute);
- Special budgets, which include technical and scientific research, survey, and some educational institutions (such as the institutes of mines survey, electrical survey, scientific and technical research, Turkish and Middle East public administration, and center for export development);
- Special funds, which include public funds established by special laws for certain purposes (such as funds for national disaster, slum prevention, selective credit, investment acceleration, traffic, small industry, and organized industrial regions).⁶

Local Administration

This group comprises three categories, which are supervised by the Ministry of the Interior: (a) provincial budgets, which include 67 special provincial administrations, each under the direction of a governor and a council; (b) municipal budgets, which include about 1,700 municipalities, each with its elected, autonomous legislative and executive bodies (such as municipal councils and mayors); (c) village budgets, which include about 35,000 village administrations.

All local administration agencies have separate budgets and accounting systems outside the central government system.

Public Economic Enterprises

This group comprises the state economic enterprises (SEE), nonfinancial public corporations, state banks, state insurance companies,

and social security organizations. These units are administered out-
side the government accounting and auditing system. The relation-
ships between this group and the central government's agencies are
reflected in the annual budget as transfer payments.

BUDGET STRUCTURE AND EXECUTION

Structure of the State Budget

The Turkish budget structure is based on four expenditure classifi-
cations:7 organizational classification of general and annexed budget
agencies; program, subprogram, activity, and project classification of
expenditure within each organization; economic classification of ex-
penditure comprising three categories such as current expenditures,
capital expenditures, and transfers; and items of expenditure classifi-
cation in terms of objects (in nine main groups).8

The revenue estimates are also included in the state budget. Under
the Turkish system, the annual budget is submitted to Parliament on
a gross basis for both general and annexed budget estimates; how-
ever, the budget (appropriation) act is voted on a consolidated basis
by deducting the revenue receipts of annexed budget agencies from
the total of the estimates.

Execution of the State Budget

The execution of the state budget involves the following transac-
tions that must be carried out in three stages by designated depart-
ments and officials to regulate the flow of funds and ensure expendi-
ture control. These checks and balances were built into the system by
the General Accounting Law.9 To illustrate the various agencies' roles
in budget execution, the relevant stages are summarized here.

The first stage is the release of appropriations by the Finance Minis-
try. The second is the allocation and suballotment of the released
appropriations to the constituent and subordinate units of a govern-
ment agency (by the respective spending departments after receiving
permission "visas" from the Court of Accounts). The third stage is
the utilization of allocated appropriations by a spending department,
through the finance and accounting offices of the Finance Ministry.

7Gülay Coskun, Program Budgeting Model in Turkey (Ankara: Budget Department, 1972),
pp. 1–12.
8Mehmet Kara, Program Bütçenin Türk Kamu Yönetiminde Uygulanması (Program Budget
9Sınası Büyüklü and Mehmet Kamiloğlu, Genel Muhasebe Konunu Açıklaması (General
This stage includes four phases: commitment, accrual, payable order, and payment instruction.

These phases must be carried out by officials designated by the General Accounting Law: (1) allocating officer, head of spending department; (2) expenditure assessment officer, staff member of a spending department; (3) finance director, staff member of the Finance Ministry—General Directorate of Budget and Fiscal Control (GDBFC); and (4) government accountant, staff member of the Finance Ministry—General Directorate of Accounting (GDA).

Central Agencies’ Roles

The Finance Ministry is responsible for formulating and executing the budget in cooperation with the SPO, UTFT, central bank, and the respective spending agencies. The GDBFC reviews, compiles, and submits the estimates to Parliament, and, after approval, releases funds to the spending agencies.

In every general and annexed budget agency a finance director representing the GDBFC prepares the budget estimates in close coordination with the respective budget and technical divisions. This official also prepares the payable orders, gets permission “visas” from the Court of Accounts, and distributes them to the second-level allocating officers. All fiscal reporting, including submission of a final accounts schedule, and other budgetary functions are carried out by him.10

The GDA is responsible for carrying out the government accounting function throughout the country. The GDA is also responsible for keeping the government accounts and books, for recording budgetary transactions and financial operations (outside the state budget), for preparing monthly statements and reports, and for submitting the final accounts to Parliament.

Spending Agencies’ Roles

The allocating officers, who are authorized to give written orders and permission to the government accountants for the payment of expenditure, are classified into two groups: first-level and second-level. In the general budget agencies, the ministers are the first-level (principal) allocating officers. In practice, the undersecretaries or assistant undersecretaries are authorized by the ministers to allocate the appropriations (through a payable order method) to their spending subunits at the headquarters level. The ministers are directly responsible to Parliament for their transactions.

10General Accounting Law, Articles 109–114.
The provincial governor, county subgovernor, the regional directors, and commanders of military units (which have accounting offices) are classified as second-level allocating officers at the provincial level. The annexed budget agencies' heads (such as undersecretary, university rector, general director) are also second-level allocating officers. The allocating officers constitute the key officials of the spending agencies from the point of view of budget execution.11 The spending agencies' expenditure assessment officers constitute the second group. They are responsible for the commitment and accrual transactions of the expenditure procedures.12 They are charged with determining the amount of payments and with preparing vouchers after the delivery of goods or completion of services. The assessment process is finalized after the vouchers are verified by the respective allocating officers. In compliance with recent changes in the General Accounting Law, the assessment officers must be designated by the Finance Ministry. They are also charged with effectiveness control.

The second-level allocating officers and the assessment officers are responsible to the Court of Accounts for their transactions.

**Accounting Officers and Accounting Organization**

A countrywide accounting network operates under the Finance Ministry, which, along with the Court of Accounts, plays a dominant role in government accounting. The spending departments do not have their own accounting and payment offices (for collecting revenue and making payments). The Finance Ministry is authorized to open accounting and payment offices where appropriate and to assign its accountants to staff these offices.

There were 1,389 accounting offices operating in fiscal year 1988. The accounting offices function within the general (1,174) and the annexed budget (215) agencies. The general budget agencies include 20 central accounting offices, 647 provincial and county finance offices, 27 customs accounting offices, 31 other organizations' accounting offices, and 377 tax offices.

The government accountants are responsible to the Court of Accounts for the accuracy and conformity of the transactions. In principle, each accountant is responsible for the transactions incurred or monitored during his assignment period.

The government accountants of the above-mentioned groups are also classified as central and/or field accountants, according to where they are assigned. There are 20 central accountants, 3 of whom have

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11General Accounting Law, Article 10.
12General Accounting Law, Articles 11, 13, and 24 (as amended).
specialized duties. The public debt accountant records the domestic and foreign long-term debt. The treasury domestic payments accountant makes and records short-term borrowing transactions (such as treasury bonds and central bank advances) as well as the transactions related to treasury loans and equity participations to public enterprises, and deals with the issues relating to revolving funds, securities and portfolios, and transfer payments to the SEEs. The treasury foreign payments accountant pays the salaries of government personnel abroad (except those of the Ministry of Foreign Affairs), makes payments to bilateral and multilateral financial institutions, and monitors letter of credit transactions.

Field accountants are assigned on a province/county basis. The Finance Ministry is represented in each province by a provincial finance commissioner, who supervises all financial services in that area. Under the commissioner’s supervision, the provincial accounting director has the status of an expenditure accountant. At the county level in each province, the Ministry is also represented by a county finance director who carries out the budgetary accounting and financial reporting services and also has the status of an expenditure accountant. If the county has no tax office, this director also functions as the revenue accountant. In 1988, there were 67 provincial finance directors and 580 county finance directors classified as field revenue accountants.

All the above-mentioned accountants are also classified as civil accountants. The customs accounting offices are included in this group. In this context, the Finance Director of the Ministry of Foreign Affairs has the status of accountant, manages the advance payments and financial transactions made to the Turkish embassies and consulates abroad, and compiles their accounts. The accountant of the General Directorate of Revenue collects special revenues such as annexed budget surpluses.

There were also 72 military accounting officers operating in 1988. The military accounting office, the military quartermasters accounting office, and the navy accounting office are described as military accounting offices.

Roles of Audit

The execution of the government agencies' annual budgets is controlled and audited by the following agencies.

Internal Auditing

Administrative control and supervision: commitment, delivery of goods, and accrual and payment procedures of the budgetary trans-
actions are examined and verified by a spending department (by expend­iture assessment officers and the finance director), then by the respective accounting office (by a government accountant).

Review and verification at the GDA level: the monthly statements and schedules of the government accountants are reviewed and the necessary corrections are made and verified at headquarters.

Control and inspection: there are three levels of control and inspection carried out by Finance Ministry officials: (1) the transactions of the accounting offices of the general and annexed budget agencies, SEEs, revolving funds, and special funds are inspected by the financial inspectors of the corps of inspectors in the name of the Finance Minister; (2) the GDA controllers control the transactions of government accountants throughout the country; (3) the examination of the government accountants' transactions is made by the provincial finance commissioners' control officers within the jurisdiction of a province; and in addition to those in the Finance Ministry, there are inspection units for internal control in certain ministries and annexed budget agencies.

External Auditing

The Court of Accounts acts in the name of the Parliament. The Court's functions are similar to those of the Auditor General's Office in other systems. The Court has two important preauditing functions: the first-level allocating officers must submit the payable orders for permission "visa" purposes; and they have to register the contracts in excess of certain amounts.\(^\text{13}\)

As for postauditing, the accounts and transactions of all accountants, assessment officers, and allocating officers are audited by the Court of Accounts. Constitutionally, this process is a judicial function performed on Parliament's behalf.\(^\text{14}\) The auditors' reports are submitted to the relevant internal department in the Court of Accounts. The findings are reviewed and judged by the prosecutor as acquitted, debited, or compensated. The Court's decisions, which are taken as debit or compensation, represent only personal financial obligations for the respective officials. However, if fraud is found, the case must be transmitted to the civil criminal court.

Special Auditing

The accounts of the SEEs and of the Turkish radio and television organization are audited by the controllers of the High Control Board of the Prime Minister's Office.

\(^{13}\)Court of Accounts Law No. 832, Article 30.

\(^{14}\)Constitution, Article 127.
ACCOUNTING STRUCTURE

Structure of Fund

The Treasury maintains a universal fund. All revenues flow into, and expenditures are paid out of, a pool. All civil, military, and special treasury accounting offices are integrated for cash management purposes. Cash circuit of the network is determined by the UTFT in close cooperation with the central bank and the (state-owned) agricultural bank. A unified treasury account method is used to monitor the cash inflow and outflow and to ensure regular and timely payments. The Treasury is responsible for maintaining a proper revenue/expenditure balance for the effective execution of the annual state budget. An overdraft facility at the central bank, which does not exceed 15 percent of the total general budget agencies’ appropriations, is used if required. The Treasury is authorized to mobilize resources through treasury or state bonds, backdoor spending, and contract authority, particularly for financing SEEs.

Under the present system, annexed budget agencies, revolving funds, special funds, and some social security organizations are outside the Treasury’s system described above.

Basis and Coverage of Accounting

Turkish Government accounting is based on a mixture of cash and accrual. On the revenue side, a cash basis is used for direct payments made in cash. However, an accrual basis is used for deferred payments, adjustment of advances, and other transactions of the complementary period. Contracts awarded by the spending agencies are recorded at the commitment or obligation phase. All expenditure is recorded at the level of payment instruction and of payment itself. Therefore the appropriations relating to expenditures that are not accrued are regarded as unused appropriations and canceled at the end of the fiscal year. Revenues are considered when they are assessed by the tax offices, but are recorded in the budget of the fiscal year during which receipts are collected, regardless of the fiscal year in which they accrue.

The current government accounting system was influenced by the French system, and the procedures of monitoring and controlling the execution of the revenue and expenditure sides of the state budget mainly follow the French pattern. The general and annexed budget agencies are within the coverage of the overall accounting plan.

15Central Bank Law, Article 50. This provision is also included in the Appropriation Act every year.
16Giyas Akdeniz, Devlet Muhasebesi (Government Accounting) (Istanbul, 1948), p. 16
Classification of Accounts

The government accounting plan was revised in 1987 and the number of accounts decreased from 105 to 52. The accounts are classified as appropriation, treasury, balance sheet, and memorandum accounts. All transactions are recorded on a double-entry basis.

Management and Cost Accounting

In compliance with the General Accounting Law, a responsibility accounting approach is used within the government accounting system. It specifies that all budgetary expenditures be charged to the accounts of the relevant government agencies. Cost accounting is used by the revolving funds attached to the commercial and industrial-oriented departmental enterprises. It comprises certain items of expenditure—such as wages, salaries, and purchases of raw materials and equipment—to determine the production costs and to prepare loss and profit statements. Cost accounting is also used by certain capital development project centers, which are financed by bilateral or multilateral sources and by some of the industrial and manufacturing state economic enterprises outside government accounting. Although some surveys have been made in the Ministry of Defense, the cost measurement and analysis techniques and the cost accounting system have still not been used by the general and annexed budget agencies.

Asset and Inflation Accounting

Asset accounting for movables and immovables is required by the General Accounting Law. The Finance Ministry (General Directorate of Public Property) is responsible for the management of all state immovables. A ledger, which shows the location, types, and values of all immovables, is used for this purpose. All maps, plans, and photographs are kept on file. Provincial property directors are considered as asset accountants for the Government's immovables (fixed assets).

Asset accounting for movables is considered for the following items: primary materials to be used for production; goods and materials to be used for consumption; materials to be used for capital expenditure; medical materials; and furniture and office equipment. Asset accountants for movables are the staff members of the spending departments. They report to the Court of Accounts.

For the accounting of movables, inflow and outflow transactions are recorded according to cost. Depreciation or valuation methods are not used for inventory accounts.

Certain inflation-accounting capitalization techniques are used only...
in some industrial or commercial companies in which the Treasury holds shares or equity. Each minister must submit to Parliament a statement of final assets showing the type and value of materials transferred from the previous year, purchased and consumed during the current year, and the year-end inventory.

**Role of EDP System**

The Finance Ministry's EDP Center was established in 1952 in the GDA; it performed only headquarters tasks owing to its limited capacity. Over the years, the computer capacity has been increased. The Center monitors appropriations, oversees staffing, prepares reports on the accounting offices' revenue and expenditure statements and 10-day account results, and consolidates statements for final budgetary accounts.

**FISCAL REPORTING**

In the Government's accounting system, a monthly and annual reporting method is used. All accountants submit monthly to the GDA the monthly trial balances, the budget revenue subsidiary accounts schedule, the budget expenditure and payable orders schedule, the budget accounts summary schedule, the previous fiscal year's adjustments schedule, the school boardinghouses' assessment, collection, and expenditure schedule, and the schedule for transactions between accounting offices.

They submit to the Court of Accounts the above-mentioned seven schedules, the journal, and vouchers and supporting documents; and to the General Directorate of Revenue the monthly trial balances and the budget revenue subsidiary accounts schedule. To the spending department's budget unit, they submit the budget expenditures and the payable orders schedule.

At the GDA, the monthly trial balances and the other statements are examined, verified, and compiled (by the sections of control, ledger, and computer) and the consolidated trial balances, revenue statements, lists of appropriations, and monthly treasury trial balances are prepared. An intermediary flash reporting system is also used by the GDA (statistical section) to collect the required monthly information by telex and telephone from the regional finance commissioners. All this information is published monthly by the GDA in the Public Accounts Bulletin.

18Government Accounting General Regulation, Article 143.
On an annual basis, the fiscal year's results are presented in the final budgetary accounts; the government accountants prepare 13 schedules for this purpose. The first 7 schedules reflect the results of the budgetary transactions (such as summary accounts, revenue assessment and collections, expenditure and payable orders, revenue assessment balances, budgetary deposits, and advances and credits); the remaining schedules (such as regular and budgetary personnel receivables, stocks and bonds, public stamps and valuable papers, assets deposits, and moneys given for subsidized operations) provide complementary information. These schedules are submitted to the GDA and the Court of Accounts to be used as a basis for the final accounts that comprise three main schedules: expenditure, revenue, and assets.

Every minister must submit the expenditure final accounts schedule to the Finance Ministry (GDA) and the Court of Accounts within six months of the end of the fiscal year. The Government must transmit the treasury general account schedule, which comprises the consolidated revenue and expenditure accounts, and Treasury's combined balance sheet to the Court of Accounts and Parliament within seven months of the end of the fiscal year. The Court of Accounts reviews the statements of accountants, the Minister's final expenditure schedules, and the Treasury's general account, and then submits the general conformity statement to the Parliament within six months.

The Turkish budget cycle is completed when Parliament approves final accounts.

MAJOR PROBLEMS AND RECENT IMPROVEMENTS

Economic Planning and Accounting

Five-year planning and program budgeting systems were introduced in the 1960s and 1970s, respectively. The government accounting system carries out the legal accountability and cash flow control functions given to it by the General Accounting Law in 1927. Although some improvements have been made, the scope of government accounting could not be enlarged to perform the function of economic planning. It should as a first step comprise the revolving and special funds. It would be ideal to include the local administration and the SEEs to improve the preparation of the national accounts. This requires a comprehensive and well-defined government

20Court of Accounts Law No. 832, Article 81.
accounting plan. In practice, however, even the accounting procedures of some annexed budget agencies differ from those of the general budget agencies, and their data cannot be consolidated with those of the central government’s accounts.

It is argued that the rigidity of fiscal legislation has led the spending agencies to look for flexibility in the form of off-budget transactions.\(^{21}\) The present practice requires careful review, not only for fiscal discipline and expenditure control, but also for improved formulation, monitoring, and evaluation of the economic, fiscal, and monetary policies.

The total number and particularly the size (volume) of special funds have been increasing in recent years reflecting the growth in extra-budgetary institutions. In view of the impact of the spread of these funds on the systems of control, it could be considered an alarming trend. If financial discipline is not restored there is a potential that it could threaten the unity of Treasury and create cash management and expenditure control problems.

The integration of asset accounting into the government accounting system, strengthened with the depreciation techniques, should also be examined. It is essential that there be close coordination among the core agencies.

Another problem relates to the economic classification of expenditure. This classification is quite limited, as it still maintains only three categories of the previous system in global terms without any meaningful subclassification. It may obscure reality and draw the attention of the spending agencies and Parliament to the inputs rather than the outputs, outcomes, and end products of the activities and projects. Appropriate criteria to govern the separation of current and capital expenditure, in particular transfers, need to be established to ensure consistent compliance over a period of time. This opportunity for specifying criteria should also be utilized to extend the classification to government lending. It is encouraging that the principal (debt) repayments have been made outside the budget as a result of recent modifications. With these revisions, the economic classification of expenditure could be used as a basis for economic analysis and planning.\(^{22}\)


Financial Management and Budgeting

The Turkish program budgeting system has been introduced as a better instrument of financial management. However, the program structures of many spending agencies have not been developed in line with their objectives, alternative programs have not been designed, and, most important, the responsible units or cost centers at the activity and project levels have not been specified as the Turkish public administration system has evolved. The whole budget program classification system therefore needs further review.

The fiscal year runs on a calendar year basis. The budget is based on a mixed accounting method and with a budgetary complementary period for the adjustment of advances, making it difficult to extract actual expenditure and revenue figures. This seriously limits cash management, accounting, and fiscal reporting. For effective financial management, a timely and reliable flow of information must be present.

The lessons learned from past experience help to achieve objectives. Parliament’s examination and approval of the final budgetary accounts are very slow. The end product may meet the requirements of legal accountability but is of no practical value to financial management. This practice could be reviewed by the legislative and executive organs.

Austerity Management and Accounting

High inflation, increasing unemployment, and decreasing economic growth rates are the general symptoms of fiscal stress in every country, and they call for effective austerity management. The core agencies need to be helped to distinguish the components of the spending departments’ programs in line with the Government’s priorities and to re-examine the revenue-raising and internal and external borrowing projections during budget formulation and execution. Although the annual program based on the five-year development plan and the program budget provides adequate instruments, the SEEs, special and revolving funds, and municipal administrations create built-in deficiencies in the existing system.

During budget execution, the release and use of funds should also be controlled according to the changes in the economic and financial variables and parameters. Under the present budgetary system, the Finance Ministry (GDBFC) has the authority to release the funds (appropriations) to the spending agencies. The released funds are also subject to the (permission) visas of the Finance Ministry (GDBFC) and the Court of Accounts according to the General Ac-
counting Law; but, in practice, the visa function of the Finance Ministry is carried out by the finance directors at the respective spending agencies. The function of the Court of Accounts is performed only for legal purposes; therefore, these functions have lost their value as budgetary instruments for macroeconomic purposes.

The state budget contains so-called automatic appropriations for certain statutory and specific expenditures. They should be reviewed closely, as otherwise they constitute a leakage, and adherence to the balanced budget is rendered impossible. By the same token, parliamentary control is also considerably weakened.

Austerity management also requires timely and consistent monitoring of the budget on a macro, organizational, and program basis. The present government accounting arrangements should be improved for this purpose.

**Financial Management Initiatives**

The recent introduction of effectiveness control is a positive step. However, the evaluation techniques, the indicators of outcome or output, and the performance criteria need to be developed. Internal and external audit agencies should supplement their financial audit methods with techniques to evaluate the findings and conclusions of the spending agencies in the areas of the efficiency, value-for-money terms of economy, and effectiveness control.

The recent improvements in the classification of accounts, books, and forms are encouraging. The momentum needs to be sustained. The satisfactory results of the pilot study on computerization initiated in Izmir should be tested in other regional centers under an integrated computerization program.

Human resource development is vital for the success of every system. The Turkish Finance Ministry has its own educational and permanent training programs and institutions; however, those institutions need to be upgraded. The professional and intellectual capabilities of its accounting and financial staff should be increased and strengthened to meet the requirements and challenges of the contemporary financial management and public administration systems.
Government Accounting in the
United Kingdom

ANDREW LIKIERMAN

INTRODUCTION

The development of financial institutions and financial systems in the United Kingdom is closely bound up with important constitutional developments over many centuries, and the origins of some of the features of today's procedures go back a very long time indeed. The Treasury has existed in one form or another since the Royal Exchequer was established in the twelfth century; the office of a key figure in the auditing of government accounts—the Comptroller and Auditor General—can be traced to at least 1314, though the role has changed considerably since then.

Much of the basis of modern government financial management and accounting was, however, formed in the mid-nineteenth century and changed only slowly until the 1970s. Indeed, at the beginning of the 1970s, judging from the writings of Goldman¹ and Diamond,² both of whom had recently retired, there was a somewhat complacent assumption that the system would need very little improvement in the future. Since the mid-1970s, however, the pace of change has accelerated remarkably, and the systems of financial planning and control have undergone what is in effect a major revolution.³ There have been three major stimuli for the changes. First, there was the

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crisis of high and variable inflation rates in the 1970s. Then came the political stimulus of a Conservative Government elected in 1979 and determined to review the operations of the public sector and if possible cut its size. Finally, and most important, through the 1970s but with increased emphasis in the 1980s, an attempt has been made to improve the management of the public sector in all its aspects. Developments in accounting have been very closely linked to the managerial changes. Before going through these developments, the following section gives a brief summary of institutions and their roles (for those unfamiliar with U.K. financial institutions). It should be noted that there are sometimes different arrangements for Scotland, Wales, and Northern Ireland.

INSTITUTIONS AND THEIR ROLES

The institutional framework for financial management must start with the constitutional position, which is the statement "The Crown demands money, the Commons grants it, and the Lords assent to the grant." What this means has been summarized as follows:

The Sovereign, being the executive power, is charged with the management of all the revenue of the State and with all payments for the public service. The Crown, therefore, acting with the advice of its responsible Ministers, makes known the pecuniary necessities of the government: the Commons, in return, grant such Supply provision as is required to satisfy those demands, and they provide . . . the ways and means to meet the Supply which they have granted. The Commons do not vote money unless it is required by the Crown . . .

The reality is less complicated in principle, though not in detail. It is up to the government of the day to propose expenditure and the taxes to pay for it. The House of Commons has to approve these proposals—it cannot itself propose increases in expenditure—and because the Government has a majority in the House of Commons, approval is normally assured. (To dispel any misunderstandings about whether the United Kingdom is still a feudal society, the Queen herself, despite the references above to "Sovereign" and "Crown," has little role to play. And the House of Lords, a nonelected chamber, has no authority on money matters.)

Although revenue is raised each year through a variety of sources, the bulk comes from the taxes raised by central government. Authorization for the raising of these taxes comes from the House of Commons on the basis of the annual budget, which proposes the tax levels

and changes, normally just before the beginning of the financial year starting in April. A debate on the proposals is held immediately after their announcement, and the Treasury and Civil Service Select Committee reports to the House of Commons on them at a later date. The details are included in the Finance Bill, which has to be considered by Parliament each year. The Bill must complete its passage through the legislature and, as amended, must be passed by early August to give the authority to the Government to levy taxes.

Of the key institutions, the most important part of government is undoubtedly the Treasury, known more formally as Her Majesty’s Treasury, which is responsible for most of the Government’s accounting and financial management functions. The planning and control of public expenditure is one of its central roles, and the Head of the Government Accounting Service is one of its senior officials. Another senior official is the Treasury Officer of Accounts, who is responsible for advising the Treasury and departments on Parliamentary expenditure matters and is the main link with Parliament. The Treasury is highly influential even in those functions for which it is not wholly responsible, such as financial relations between each department and Parliament.

The Treasury’s pivotal role in planning and controlling revenue and expenditure and acting as the focus for the development of managerial and accountancy practice is reinforced by several of its other functions. One is its duty to advise departments on economic and financial matters, which means in practice that they can do little without Treasury approval. Also important is its influence on pay negotiations and its close links with the Customs and Excise (whose responsibilities follow its name) and the Inland Revenue (responsible for administration of most of the other taxes).

Responsibility for implementing managerial change is divided between the Office of the Minister for the Civil Service (part of the Cabinet Office) and the Treasury. Separate from both is the Efficiency Unit, which works directly for the Prime Minister’s adviser on efficiency. In addition to its other work, the unit is involved in a limited number of efficiency scrutinies (see below), leaving the majority to be conducted within departments.

The department with responsibility for many of the mechanics of payments and receipts within government is the Paymaster General’s Office. This responsibility is in three main areas: paying public service pensions, providing banking services to the Government, and supplying information on central government expenditure to the Treasury and other departments.

Individual government departments have an accounting officer (usually the head of the department) responsible to Parliament for
good management in prudent and economic administration. Among his or her main responsibilities is the duty to sign the Appropriation Accounts each year and ensure the regularity and propriety of expenditure from public funds. Support for financial work in departments is provided by the principal finance officer (PFO), who is responsible for financial and accounting matters within the department and will normally liaise closely with the Treasury. Detailed work within departments will usually involve Finance Division(s) and the Accounts Branch. The former deals with the processes of approving the financial content of proposals, obtaining the necessary funds, and promoting efficiency. The latter brings to account the payments and receipts and maintains proper books. Internal audit will also report to the PFO, though there will be access to higher levels if necessary.

On the parliamentary side there are also a number of key institutions. On the auditing side they are the National Audit Office (NAO) and the Public Accounts Committee. The NAO’s routine audit work is to ensure propriety and to ensure that the sums granted by Parliament have been used for the purpose intended. It is concentrated after the end of the financial year when departmental accounts are prepared as part of the certification process. The remit of the NAO, however, goes wider, since it is also charged with examining economy, efficiency, and effectiveness (that is, value for money). It is completely independent of government and is responsible to a commission of senior parliamentarians.

Reports of the NAO are issued under the signature of its head, the Comptroller and Auditor General, whose independence of government is similarly provided for. The NAO also examines (but does not certify) the accounts of government revenue. Its other activities include certification of the accounts of other public sector bodies and some international organizations. Apart from the formal audit, the NAO raises issues in its management letters, generally to recommend improvements in accounting systems, although errors and queries are also drawn to the attention of management.

The Public Accounts Committee role can be highly influential, since its duties are to consider not only the Appropriation Accounts and other accounts presented to the House of Commons but also value-for-money reports on government activities. This consideration is normally through examining the accounting officer as the responsible departmental official on matters that have been brought to its attention. The Treasury replies to these reports through Treasury Minutes, and there is a parliamentary debate on some of the reports of the Public Accounts Committee and relevant Treasury Minutes.

For scrutinizing expenditure plans, the departmental Select Committees, of which there are currently 13, play key parliamentary roles.
Of the committees involved in scrutinizing government proposals, the Treasury and Civil Service Select Committee is the most prominent, reflecting the fact that it "shadows" the departments most concerned with financial matters. It has the general responsibility for examining economic policy and submits reports to the House of Commons as a whole to inform their general debates. Accounting and civil service management issues also come within its work. Other departmental Select Committees are less directly involved in these matters, although each has the opportunity to review and report on annual expenditure proposals, by questioning officials and/or ministers about expenditure plans.

**MAJOR EVENTS SINCE 1970**

Although it is now usual to regard the majority of the considerable changes in the activities covered in this chapter as occurring in the 1980s, the impetus of the Fulton Report published in 1968\(^5\) helped to set the process of reform in motion. Improvements in the 1970s were piecemeal, however, and had less of a financial emphasis than those of the 1980s. In comparison with the 1960s, nevertheless, the pace of change of management in general and the financial planning and control framework in particular was already fast in the 1970s. It accelerated considerably in the 1980s, with change affecting almost all parts of the system. Only a brief allusion, however, can be made to the major innovations.

**Planning and Control**

The period was marked, above all, by intensive efforts to establish and maintain control over government expenditure. Until 1982, planning was in "volume" terms, with the emphasis on providing a required quantity of goods and services. A major development in 1976 was the introduction of cash limits—the net amount of cash that can be spent on services during a financial year—which ignored the volume element of spending.\(^6\) These limits were enlarged and consolidated in later years to cover about 60 percent of public expenditure.

The introduction of cash limits was a response to the uncertainties of planning in volume terms at a time when high and variable inflation rates were giving rise to concern that public expenditure was


"out of control" and based on "funny money." The limits were operated in parallel with a planning system still using constant prices until 1982 when "volume" planning was abandoned and government expenditure plans also were expressed in cash terms, allowing limits to be integrated with plans.

Recognizing that cash controls might give rise to problems, in 1983-84 an end-year flexibility scheme was introduced to allow a limited amount of certain capital expenditure allocations to be carried forward to the following year. The intention was to recognize the difficulties of planning such expenditure and to avoid a potentially uneconomic rush to spend at the end of the financial year.

In addition to cash limits, other controls were introduced during the 1980s as a means of exerting pressure to keep administrative costs down. These included both financial and nonfinancial measures. Of the financial measures, running cost controls are worth mentioning, three of which were introduced in 1986, and which in effect act as a cash limit within the cash limit for certain administrative costs. These limits are also monitored during the year.

One of the most difficult areas in the exercise of expenditure control has been in central government’s dealings with local government. In 1980 the Conservative Government passed the Local Government Planning and Land Act, which introduced a number of additional expenditure controls to those already in place, as well as inaugurating a "block" grant in an attempt to simplify the system of subventions to local authorities. But during the next few years, tension built up between some local authorities controlled by the opposition Labor Party and central government. Since local authorities are able to raise some of their own revenue, such authorities were able to circumvent the spending controls imposed by central government. The result was a succession of measures designed to stop them. Spending limits were introduced in 1981 but were not successful and were later scrapped. In 1982 the Local Government Finance Act was passed, altering the basis of grant and audit, and in 1984 the Rates Act, designed to stop using local taxation to fund additional expenditures. In 1988, there was another Local Government Finance Act, which altered the whole basis of local taxation. Further legislation was promised.

The period was also marked by attempts to control the amounts that nationalized industries could receive from central government. Like local authorities, nationalized industries proved difficult to control, not only because of trading uncertainties, but also because of ambiguities over policy objectives. The attempts to establish a control framework that had been the subject of debate for many years, culmi-
nated in a White (policy) Paper in 1978. Cash controls through external financing limits were introduced as part of a comprehensive control framework to include targets usually based on rates of return and nonfinancial measures. Although the framework in the White Paper lasted for many years as the basis of policy, by the middle of the 1980s the Government had effectively decided that it would sell off as many industries as possible to the private sector. The control problem was thus effectively resolved.

Reflecting the rate of change in procedures and parliamentary interest in monitoring and control, there were also major changes in the financial documents produced by the Government. They are described in detail in the section on the structure of the accounting system, but it is worth noting the rise in importance (and the huge improvement in presentation) of three information documents—the Autumn Statement, the Public Expenditure White Paper (PEWP), and the Financial Statement and Budget Report (FSBR). The first two of these merit further consideration. The FSBR, while expanded in scope and gradually becoming more approachable, fulfilled a similar role throughout the period.

The Autumn Statement had its origin in a report by an independent study group chaired by a former head of the civil service. The Treasury and Civil Service Select Committee recommended that a "Green" (proposed) budget should be published in the autumn, to allow time for discussion by Parliament and others. The Government rejected the idea of submitting proposals for general consideration but instead published a document, the Autumn Statement, which has become progressively more important since first published in 1982.

The second document, the Public Expenditure White Paper, was started in the late 1960s, but it became the main focus of parliamentary scrutiny of expenditure in the 1980s, until, with the growing importance of the Autumn Statement and the decision to phase in Annual Reports for Government Departments, it was planned to phase it out altogether by 1991. Reflecting the changes in the planning system, the figures in the PEWP were at first expressed in vol-
ume terms. However, after the problems of running a constant price planning system in a period of high and variable inflation rates, the PEWP mirrored the planning system and was expressed in cash terms from 1982.

One result of all these changes was that it became more difficult for outsiders to understand what expenditure figures meant. At the beginning of the period, information was based on a traditional system of parliamentary control of expenditure built on principles established in 1866. With the arrival of cash limits in 1976, a parallel system of control emerged, and for a time the "traditional" documents classified information in a way that was difficult to reconcile with those for cash limits and with the increasingly important information documents. There has been increasing alignment of the three throughout the 1980s, however, until it has become relatively easy to read across from one document to another.

Management

One of the first actions of the Prime Minister of the incoming 1979 Conservative Government was the appointment of Lord (then Sir Derek) Rayner as efficiency adviser. He initiated a system of scruti­nies, since then commonly known as the "Rayner scrutinies," which were not only important in their own right as examples of how studies carried out within a government department in a short timeframe could identify possible efficiency improvements, but they also gave rise to different ways of thinking about management that generated a number of specific management improvements within departments.

One example was the development of top management information systems within departments, of which MINIS (Management Information System for Ministers) in the Department of the Environment was the model for versions later modified in many other departments.

Rayner's work was also influential in the thinking behind the Financial Management Initiative (FMI). The FMI, announced in a White Paper, gave as an objective that departments should have

a. a clear view of their objectives and the means to assess and wherever possible measure outputs or performance in relation to these objectives.

b. a well-defined responsibility for making the best use of their resources, including a critical scrutiny of output and value for money.

c. the information (particularly about costs) ... which they need to exercise their responsibilities effectively.

This rather limited exercise in improving financial management, as Richards pointed out, "has come to symbolise all that has happened in the field of management change in the public sector. . . . It is a catch-all label commonly applied to all the current attempts to improve efficiency and effectiveness, such as importing commercial principles of management, improving the financial skills of civil servants, buying in goods and services through contracting-out rather than producing them in-house, and so on." \(^{11}\)

The FM1 indicates the close connection between the financial and more general managerial changes that took place in the 1980s as well as emphasizing the importance of budgeting, control, performance measurement, and value for money as key elements of many of the later managerial innovations. The theme of allowing the development of devolved budgeting was reinforced in the multidepartmental review of budgeting,\(^{12}\) although there was soon clear evidence that central control had been loosened only to a very limited extent.\(^{13}\) Similarly, while there was evidence of progress over what had been available before,\(^{14,15}\) there was limited progress too in the development and use of performance measures.

The idea of devolving managerial responsibility was taken much further with the publication of a report by the Efficiency Unit known as "The Next Steps." This recommended that "agencies" should be established to carry out the executive functions of government within a policy and resources framework set by a department,\(^{16}\) that staff should be properly trained to do so, and that an official at the most senior level should be appointed as "project manager" to carry it through. The recommendations were endorsed by the Government and by Parliament,\(^{17}\) the official was appointed, and at the time of writing, the initiatives were being pursued with considerable vigor. Several agencies had already been created and agency arrangements were being discussed with many more organizations.

In the accountancy area, the period saw an important development with the introduction of a new post, Head of the Government Accountancy Service. This post was created following government acceptance of the 1973 Melville/Burney Report, which recommended that the duties of the post should include career management of the Government Accountancy Service and development of closer relations with accountants outside the civil service and with senior administrators. It proved difficult to recruit the first two incumbents of the post, but the position gradually gained in stature as it was transferred into the Treasury from the Department of Industry and the importance of the work became more clearly established.

Parliament

For Parliament, too, the period has been marked by significant changes, with two factors of major importance. First, there has been a resurgence in House of Commons activity in the scrutiny of expenditure after many years of playing a relatively insignificant role. This activity has been stimulated above all by reforms recommended by the House of Commons own Select Committee on Procedure in the 1977-78 session and implemented in 1979. The reforms provided for the setting up of departmental select committees to shadow the affairs of government departments and provide a more effective mechanism than had hitherto existed to enable them to scrutinize government expenditure plans. Further changes from the 1982-83 session made three days available each session for debates on expenditure matters raised by the committees.

The second major parliamentary change has been in the way the focus of the Public Accounts Committee has moved away from having matters of propriety and regularity as the main part of their work to concentrating on the value-for-money aspects of expenditure. This change was made possible above all by the creation of the National Audit Office in 1984. Through the National Audit Act 1983, the NAO took over the functions of the Exchequer and Audit Department, which had dated from reforms in 1866. Until the 1983 Act, value-for-money examinations were carried out only with parliamentary encouragement. Thereafter they had statutory authority for the first time.

In parallel with the emergence of these new roles, there was a dramatic improvement in the nature and quality of the financial information provided to Parliament. The long-established documents that
provided the material for parliamentary scrutiny were still produced, but their relative importance was eclipsed by a group of new documents whose focus was largely on planning and information. These documents, notably the Public Expenditure White Paper, at first operated more or less independently from the traditional documents. Progressively the two became aligned.

**STRUCTURE OF THE ACCOUNTING SYSTEM**

While the structure of the accounting system has undergone considerable change in recent years, the basis of the system remains, however, annual and cash based, though certain transactions involving revenues are on an accruals basis. Two exceptions to the general pattern are public corporations—which use conventional commercial accounting (with special variations)—and, since the 1973 Trading Funds Act, trading funds. The intention behind the Act was to allow improved commercial operation and public accountability for certain central government trading entities by providing a more commercial framework in which to operate. But in practice trading funds have been little used.

The Government’s funds are handled centrally through the Consolidated Loans Fund—the Government’s bank account kept by the Paymaster General’s Office. Taxes and receipts other than those relating to loans are paid into it, and most government expenditure (including all funds granted by Parliament) are financed out of it. All relevant payments have to be authorized by the Comptroller and Auditor General to ensure that authority has been given for the payment. Certain items of expenditure come straight out of the Consolidated Fund and do not have to be voted by Parliament annually through the supply procedure (see below). These “Consolidated Fund Standing Services” include payments to service the National Debt and payments to the European Communities.

Two other key funds are the National Loans Fund and the National Insurance Fund. The former deals with borrowing and debt interest. Balances from the Consolidated Fund are paid each day into the National Loans Fund to minimize government borrowing. As a matter of long-standing principle, all revenues are paid into the Consolidated Fund and all expenditures are paid out of it. One exception in theory but not in fact is the National Insurance Fund, which is under the control not of the Treasury but of the Department of Social Security. This fund receives social insurance contributions from employers, employees, and the self-employed as well as government contributions voted by Parliament. These moneys pay for contributory-based benefits such as retirement and widows’ pensions and...
unemployment and invalidity benefits. In practice, the flows into and out of the fund form part of the general pool of government revenue and expenditure.

PLANNING

Government planning systems are in cash terms and operate for a period of three years, known as the survey period. They are conducted against the background of the Government's medium-term financial strategy. The annual planning cycle starts in January, 15 months before the beginning of the financial year. In the months that follow, Treasury officials work with officials from other departments to draw up proposals to cover three years in a process known as the public expenditure survey. The Treasury Minister responsible, the Chief Secretary to the Treasury, presents the results. Ministers become involved at the later stages of the process and a Cabinet meeting (usually in July) decides the overall totals of public expenditure for the three years. In the case of the first two years, it is a question of deciding whether the plans agreed should stand or whether they should be altered.

Following the announcement of the total, departmental bids have to be reconciled with what has been announced. The Chief Secretary to the Treasury discusses whether this can be done with relevant ministerial colleagues in charge of spending departments. If no agreement can be reached through these "bilaterals," a group of ministers known as the "Star Chamber" arbitrates between the competing claims. The decision about the allocation of the total between departments is usually taken in November and published in the Autumn Statement, together with an estimate of the out-turn for the current financial year. A report on this document is made to the House of Commons by the Treasury and Civil Service Select Committee and forms the basis of a debate shortly thereafter. Full details of what each department will spend will be published in January up to 1990. From 1991 onward the information will be included as part of annual departmental reports that will be published in March.

Parliamentary departmental select committees have a chance to discuss these proposals and the supply estimates that are issued at the time of the budget. The supply estimates are the formal request to Parliament for funds and cover most, though not all, public expenditure (the balance consists mostly of local authority expenditure and social insurance funds). Parliamentary approval for the proposed expenditure must be given by early August. Time for parliamentary debate (Estimates Days) on issues raised by departmental select committees is set aside three times a year to allow consideration of mat-
ters chosen from those estimates (or supplementary estimates asking for additional funds) discussed by the committees. Individual matters can be brought to the attention of Parliament at any time by individual members of Parliament.

**CONTROL**

Central control and monitoring of expenditure during a year comes through the Financial Information System (FIS), which provides regular reports on what has been spent and the estimated outturn for the year. Departments draw up a quarterly profile of expected expenditure, which is agreed with the Treasury. Much information for monitoring comes each month from the APEX (analysis of public expenditure) records of receipts and payments to the Consolidated Fund maintained by the Paymaster General's Office. Further information on half-yearly estimated expenditure is given by departments, each of which has an internal monitoring system, together with any revisions to budgets believed to be necessary. These figures are used to give estimated outturn figures in the main published documents on expenditure.

Control is also exercised on about 60 percent of government expenditure through cash limits that provide a system of government control of expenditure during a financial year. The other 40 percent consists mainly of expenditure which is "demand led," that is, where policy has already determined entitlement to payments and where the expenditure is therefore effectively outside the direct control of government. Social security payments are an example. Once set, the limits are not normally changed.

Flexibility to meet unexpected events is nevertheless available during the year. First, for public expenditure as a whole, there is the reserve, which is an amount set aside at the beginning of the year to cover unforeseen items of expenditure and those items that cannot be properly quantified when plans are published. This applies even to those elements that are cash limited, where there is some flexibility. Cash limits can be revised during the year, and not infrequently are, though like all revisions, they will have to be approved by the Treasury.

Parliamentary control is exercised by the way in which the supply estimates are drawn up. These estimates restrict what the funds that are voted can be spent on (although a limited amount of switching within what is voted—virement—is available), stipulate that this is the maximum amount, and that it is approved only for the financial year. The Public Accounts Committee ensures that these provisions are adhered to as well as investigating value-for-money aspects.
Assuming the relevant item falls within the supply estimates, use of the reserve and increases in cash limits will require the approval of Parliament, normally through a supplementary estimate. The exceptions are where the expenditure is covered by a cash limit but not by an estimate, such as for much local authority capital expenditure. Pending this approval, the Government can use a contingencies fund for urgent expenditure, subject to certain restrictions.

Penalties for exceeding limits are largely moral, though there are financial penalties too. If supply estimates are exceeded, there will be an excess vote and, depending on the reasons, recriminations from the Public Accounts Committee. In the (rare) cases where a cash limit is exceeded, there will be an investigation into the reasons, and the amount set aside for the next year will usually be reduced.

**FISCAL REPORTING**

References have already been made to the key reporting documents in the previous sections. It is clear that there have recently been major developments and that they are continuing. The rest of this section gives a summary of the features of these documents, which can be divided into three categories describing their major purposes—those providing information, those required for authorization, and those that provide accountability.

Information documents are the Autumn Statement and its statistical supplement, Departmental Reports, and the Financial Statement and Budget Report (FSBR). The Autumn Statement usually comes out in November giving a summary of economic prospects for the coming financial year, an outline of public expenditure for each department for the next three years, and other information, including tables showing the effects of illustrative tax changes. Its statistical supplement (until 1991 appearing as part of the Public Expenditure White Paper), published in January, analyzes and gives more detail about the overall plans announced in November.

The other information documents are departmental reports, which will be published in March from 1991 onward, giving full details about expenditure for each department in the context of policy objectives. Until 1991 a more limited form of the detailed departmental information will be published as Public Expenditure White Paper booklets in January. The final information document is the FSBR, which is published at the time of the budget, normally in March. It gives the macroeconomic background to the budget as well as details of budget tax measures.

At the same time as the FSBR is published, the first set of main
authorization documents also appears. These are the supply estimates that give the information on expenditure to be authorized by Parliament in July or August through the Appropriation Act. Supply estimates also provide the basis for comparing estimated with actual expenditure and act as a highly detailed source of reference on expenditure items. Since the financial year starts in April, authorization comes four months after the beginning of the financial year. This is made possible by a Vote on Account granted before the beginning of the financial year to allow government operations to continue.

Accompanying the publication of supply estimates is a "summary and guide" that gives, as the title indicates, a summary of the detailed estimates and a (very useful) guide to readers on procedure and content of the documents. Other authorization documents are the revised estimates, which set out variations from the original supply estimates if known before the latter are authorized by Parliament; and supplementary estimates, which are presented at set times with requests for any additional funds. As noted above, sums that have been spent without parliamentary authority have to be authorized by Parliament through Excess Votes and these are gathered after the end of the financial year in a request for funds called Statements of Excess.

Finally, there are the accountability documents. The Appropriation Accounts are published by the National Audit Office a few months after the end of the financial year and give the details of the amounts spent compared with the sum granted by Parliament. The Appropriation Accounts will normally certify that this is so, but the accounts may be qualified if the NAO is not satisfied with them in some way. The grounds for qualification include departments spending more than authorized or uncertainty about the values of assets or liabilities. The NAO also produces value-for-money reports throughout the year covering matters of economy, efficiency, and effectiveness. An accountability document not covered by the NAO is the Cash Limits White Paper produced annually in July. It compares the original limits set, unless amended, with the outturn for the previous financial year.

The major documents set out above are supplemented by a large number of other reports, among which are the regular annual reports of many public bodies, some produced because of statutory obligations, others largely for public relations reasons. Outside the main systems of planning, control, and accountability, figures for National Accounts are produced that follow internationally accepted principles. They cover a wider field than those transactions involving only government income and expenditure and have included, though not on a regular basis, balance sheet information for all sectors of the economy comprising information on tangible, intangible nonfinan-
cial, and financial assets and liabilities. The National Accounts data are used primarily in analyzing macroeconomic variables and in providing the basis for economic forecasts.

A first attempt at a financial accounting and reporting framework has recently been published for central government. This framework, produced in response to a request from the Public Accounts Committee and that may well be further developed, sets out principles underlying the preparation and presentation of financial statements by central government. The purposes of the published financial documents are categorized as being to:

(a) Describe its financial strategy and, in particular, explain how revenue projections, expenditure plans, and forecasts of borrowing intentions fit together within the strategy;

(b) Set out the Government's proposed changes in taxation and its public expenditure needs and plans in a form suitable for parliamentary scrutiny;

(c) Provide an analysis of expenditure incurred and of outputs secured;

(d) Set out the income and expenditure of central government, local authorities, and the rest of the public sector; and

(e) Describe developments in the economy as a whole.

The framework for the documents is defined in terms of objectives (accountability, propriety and regularity, and auditability), concepts (prudence, consistency, materiality, matching, and accruals), and characteristics (completeness and relevance, timeliness, objectivity, cost effectiveness, and reliability).

MAJOR PROBLEMS AND RECENT EFFORTS TO OVERCOME THEM

The pace of innovation in the last 20 years has meant significant advances in government accounting and financial management. The ability to control the level of expenditure, both in total and at a detailed level, has improved dramatically. The standard of financial management is getting better as part of the improvement of management generally. Financial reporting, too, is of a much higher standard. But a number of problems remain, and certain issues continue to be the subject of vigorous debate. Some of these issues and problems are discussed below.


In the sphere of the management of government expenditure, the new control mechanisms continue to be controversial, though the problems are now more detailed than those that faced governments in the 1970s. Most of these problems are evident in other countries and indeed many are similar to those faced by private sector organizations.

Coping with the effects of inflation is one such problem. Although inflation in the 1980s was nowhere near the levels of the 1970s, accommodating the relative price effect—the phenomenon of prices in the public sector changing at a different rate to prices in the economy as a whole—is still a problem, particularly in those services such as defense, health, and road construction, where the relative price effect is significant. The response of the Government has been to put the onus for accommodation on the managers of each program and not to allow for the effects of differential inflation. But this action has undoubtedly caused some problems in programs failing to deliver the services that were assumed when plans were drawn up. It is true that the reserve is available for such cases, but its use in compensating for higher than expected prices has been discouraged. Whether the emphasis on control of cash outgoings is better than the loss of control by allowing for differential inflation rates is still a matter of debate outside government. Official policy is adamant about the primacy of control.

One controversy that has arisen from the introduction of the control mechanisms combined with the Government’s professed desire in the 1980s to restrain expenditure has been whether capital expenditure has borne an unfair burden as a result of the controls. It is of course true that public sector capital expenditure cannot be strictly compared to the definition used in the private sector, and whether capital expenditure has suffered from having to keep within overall limits is not easy to establish. Circumstantial evidence indicates that it has, and there is little doubt that public sector pay settlements in the 1980s have been higher than planned. To accommodate these, as two academic observers of the scene noted at the beginning of the decade: “At the end of the day, the quickest and easiest cuts remained those achieved by delaying or reducing capital spending, not cutting ‘chaps’ . . . ,”\(^2\) sentiments echoed by a former Treasury Minister in a revealing book on his experiences.\(^2\)

On the managerial side, the potential conflicts between more devolved management and central control of expenditure have also


been the subject of concern. As noted above, many of the key elements of the FMI involved greater decentralization of expenditure. But as many have observed, with each move to give greater freedom of responsibility at lower levels in the organization the Treasury has been anxious to ensure that there would be no resulting loss of their control over expenditure. This situation gave rise to some disillusionment among managers when it was realized that the limits of financial freedom were to be tightly drawn. The creation of agencies is potentially of great significance in providing a much more flexible managerial framework for what could cover a great many parts of central government. It remains to be seen, however, how many organizations will qualify for agency status, what the rules will be, and how those rules will be interpreted.

Another managerial problem has been that the development of measures of performance in recent years has lagged behind the developments in financial control—partly because the effort in this field has not been as great as in other aspects of management and partly because of the problems of developing proxies for final output. As a result there has been only patchy progress among departments, a lack of standardization, and not enough attention devoted to quality and the trade-offs between different performance measures. Despite these problems, increasing sophistication is evident in these measures, and examples have been published that give an idea of the range of activities for which measures can be found and implemented.23

A subject of general discussion has been whether the public sector should be more "like" the private sector. This subject has been raised in the context of financial reporting and control as well as for managerial issues more generally. In the case of managerial practice, considerable discussion has taken place on whether the differences in institutional framework, the nature of accountability, and the political context of management make it difficult to transfer practice from one to the other. Despite these doubts, transfers have been made and some have undoubtedly been successful, while others have not.

For financial reporting there have been those who have advocated accrual accounting, arguing that cash accounting gives insufficient information on the use and depletion of capital, making it difficult to see whether replacement and maintenance are falling behind. They have also argued that cash accounting gives rise to the danger of

misallocating resources if capital is apparently “free.” Those who have argued against have pointed to the absence of output measures, the difficulties of valuing public sector assets, and the problems of distinguishing between capital and current items of expenditure. The importance placed by the Treasury on the primacy of cash for macroeconomic policy has in any case meant that these arguments have made little headway.

On the parliamentary side, although improved mechanisms now exist for assessing and controlling government expenditure along with improved information for doing so, it is not yet clear whether these mechanisms have been as effective as originally hoped. The quality of public expenditure monitoring by select committees is patchy, and those who had hoped for a much more active role by Parliament have been disappointed by the lack of effort given to scrutiny by individual departmental select committees. Ann Robinson doubts the level of interest of members: “If MPs are not, at heart, interested in the control and scrutiny of public expenditure, then all the procedural changes in the world will hardly encourage them to change their attitudes.”

The Public Accounts Committee also, while receiving information that is now far more oriented to value for money, has been felt by some to be too narrow in its interpretation of accountability. Together with the NAO it has been criticized for not taking into account the importance of the managerial aspects of government operations.

One result of this huge increase in the scope and complexity of work in all the areas mentioned above is that there has been a major problem in recruiting and retaining the right caliber of people. Both the Government Accounting Service and the NAO have found it difficult to offer competitive salaries for capable professional staff at a time when such staff were also in great demand in the private sector. As a result, progress has been slower than hoped in some areas, and a good deal of work in departments has had to be offered to outside consultants. Bearing in mind the constraints of public sector pay, there is no obvious solution to this problem, and unless there is more flexibility in remuneration structures it seems likely that the use of outsiders will have to continue.

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Recent Developments in Accounting and Financial Management in the United States

RON POINTS

The Federal Government of the United States is the country’s largest single employer and consumer. It dwarfs the major multinational corporations in terms of revenues, expenditures, and assets. For example, the Federal Government owns one third of the total U.S. land mass, employs over five million civilian and military personnel, and accounts for more than $2 trillion in cash flow annually.

To focus better on the magnitude of the dollars involved, a comparison of the amounts as a percentage of the U.S. gross national product (GNP) might be helpful. Over the past decade federal revenues as a share of GNP increased from 18.1 percent to 20.2 percent. During the same period federal expenditures rose from 17.6 percent to 23.9 percent.¹ In short, the Federal Government is big business.

BRIEF HISTORY

The foundation of federal government accounting and financial management is in the Constitution of the United States and in an Act of Congress of 1789. Article I, Section 9, of the Constitution provides that: "No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and

account of receipts and expenditures of all public money shall be published from time to time."

The Treasury Act of 1789 provided for the first auditor and comptroller in the Department of the Treasury.

The current financial management structure in the Federal Government has its genesis in the period following World War I. It was during this period that the Federal Government became more visible to the citizens as a result of the enactment of the federal income tax and the dramatic increase in federal expenditures because of the war. Therefore, the cost to operate the Federal Government and the management of public finances became a major concern to the citizens as well as to Congress.

Budget and Accounting Act of 1921

The first landmark piece of legislation on financial management was the Budget and Accounting Act of 1921. The Act created the Bureau of the Budget within the Department of the Treasury and required the President to submit an annual budget to Congress for approval. It also created the General Accounting Office (GAO) in the legislative branch and moved the Comptroller General from the Treasury Department to the newly created position in the GAO. The new GAO was to act as the congressional independent auditor over executive branch expenditures.

Budgeting and Accounting Procedures Act of 1950

The second major legislative effort that addressed financial management was the Budgeting and Accounting Procedures Act of 1950. The more significant provisions of that Act include

- Preparation of the budget on a performance basis, with financial information provided in terms of the functions and activities of the Government;
- Promulgation of accounting principles, standards, and related requirements by the GAO, to be observed by the executive agencies;
- Establishment and maintenance by heads of executive agencies of systems of accounting and internal control, in conformity with the standards prescribed by the GAO;

Cooperation by the GAO with the agencies in developing their accounting systems; and
Review and approval by the GAO of agency accounting systems.³

The Bureau of the Budget was transferred in 1939 from the Treasury Department to the Executive Office of the President. In 1970 the Bureau of the Budget was reorganized into the Office of Management and Budget (OMB). The new office not only absorbed the budgeting responsibilities but also a number of management responsibilities, including

• Improvement of government organization, information, and management systems;
• Development of new information systems to provide the President with needed performance and other data;
• Improvement of governmental budgeting and accounting and financial reporting; and
• Improvement of governmental budgeting and accounting methods and procedures.⁴

**Congressional Budget Act of 1974**

Following creation of the OMB, Congress enacted a major piece of legislation to change the congressional budget process. In 1974 the Congressional Budget and Impoundment Control Act was passed with the following significant provisions:

• Establishment of the congressional budget process;
• Creation of the Congressional Budget Office; and
• Change in the federal fiscal year from July 1 through June 30 to October 1 through September 30 to allow sufficient time for the new congressional budget process.⁵

**Other Legislative Initiatives**

During the late 1970s and early 1980s there have been numerous initiatives aimed at improving financial management in the Federal Government. Those initiatives were

⁴Ibid.
• The Inspectors General Act of 1978 created Offices of Inspectors General in the major departments and agencies as a more effective means of coordinating the previously separate audit and investigation activities.

• The Federal Managers’ Financial Integrity Act of 1982 required heads of departments and agencies to perform annual evaluations of their internal control systems and report the results to the President and to Congress. In addition, they must report annually to the President and to Congress on whether their accounting systems conform to the principles, standards, and related requirements prescribed by the GAO.

• The Debt Collection Act of 1982, as amended, required that a comprehensive credit management program shall be established by each department and agency to assure collection of all amounts due to the Federal Government, to enable management to evaluate credit policies, to provide efficient and effective account servicing, and to improve the accuracy and timeliness of financial reports related to debt collection.

• The Prompt Payment Act of 1982, as amended, required the Federal Government to pay its contractors within 30 days after receipt of an invoice or according to prevailing industry practices, or pay interest.

Because senior financial managers within the Federal Government are not aggressive in developing good financial management policies and practices, Congress tends to pass more and more specific legislation concerning financial management as indicated by the recent initiatives discussed above.

FINANCIAL MANAGEMENT ROLES AND RESPONSIBILITIES

From the time that the U.S. Government was established, financial management was viewed as a shared function between the legislative and executive branches of the Federal Government. The Constitution gives Congress the power to allocate the resources of the Federal Government, which is accomplished through the budget process. The executive branch was charged with administering the activities of the Government and with reporting on its stewardship to the Congress as well as to the citizens.

The individual and shared financial management roles and responsibilities within the Federal Government are illustrated in Chart 1. The major financial management roles and responsibilities are discussed briefly below.
Chart 1. Organization Chart of Federal Government Financial Management Functions
Office of Management and Budget

An agency within the Executive Office of the President, the Office of Management and Budget’s primary functions are to assist the President in the preparation of the budget and the formulation of the fiscal program for the Federal Government; supervise and control the administration of the budget; review the organizational structures and management procedures of the executive branch to ensure that they are capable of producing the intended results; evaluate the performance of federal programs and serve as a catalyst for improving interagency and intergovernmental cooperation and coordination; and keep the President advised of the progress of activities by departments and agencies with respect to those proposed, actually initiated, and completed.

Critics of financial management within the Federal Government point to OMB’s preoccupation with the first function above—budgeting—to the detriment of the other functions. However, during the 1980s OMB has made far more effort to recognize the “management” aspects of its mission, as illustrated by its recent financial management reform initiatives.

Treasury Department

The Department of the Treasury serves as both the Government’s accountant and banker. Its major functions include providing services in support of the management of the public debt; maintaining a system of central accounting and reporting for the Government as a whole; acting as the Government’s banker for the collection and disbursement of funds; being responsible for cash management policies and procedures; investing Federal Government Trust Funds; determining the reporting requirements necessary to gather financial management data, working with departments and agencies to ensure the integrity of financial data reported, and establishing central accounting and reporting policy for the Federal Government; and providing departments and agencies with regulations relating to central accounting and reporting, payroll, disbursing, and the federal depository system.

It should be noted that the Treasury’s accounting focus is generally limited to what will enable departments and agencies to provide the information it requires to meet its central financial reporting mandate.

General Services Administration

The major functions of the General Services Administration (GSA) include managing the federal government inventory and property,
including construction and operations of buildings; establishing policy and procedures for records management; procuring and distributing supplies; establishing policy and procedures for transportation and travel; managing the government-wide information management resource program; and preparing annual reports of real property owned by the Federal Government based on departments and agencies reporting.

A basic problem with the GSA property records function is that it is not integrated with other financial reporting systems, and the accumulated property costs included in the GSA’s reports are not reconciled to other financial reports prepared by the departments and the Treasury Department.

Office of Personnel Management

The chief financial management duties for the Office of Personnel Management are determining policy and procedures related to employee compensation, including pay, leave, retirement, insurance, and other personnel benefits.

General Accounting Office

The General Accounting Office (GAO) is responsible for assisting Congress in its oversight of the executive branch in carrying out enacted programs. It audits and evaluates programs, activities, and financial operations of federal departments and agencies as well as their contractors and grantees, and makes recommendations for improving the efficiency and effectiveness of government operations. GAO’s primary financial management functions include prescribing accounting principles, standards, and related requirements for executive branch departments and agencies; cooperating in the development and improvement of agency accounting and financial management systems; reviewing and approving departments’ and agencies’ accounting systems; and auditing the programs, activities, and financial records of the Federal Government and reporting the audit results to the Congress and departments and agencies.

Congressional Budget Office

The Congressional Budget Office was created to provide Congress with information regarding the budget and related issues. Its specific duties include economic forecasting and analysis of fiscal policy; cost estimates of proposed legislation; an annual report on the budget; and special budget-related studies as requested by the Congressional Committees.
The Missing Link

When reviewing the overall federal financial management structure, a most glaring problem emerges: No single organization exists that bears responsibility for directing or carrying out the Federal Government's financial management functions. This "missing link" has resulted in fragmentation and overlap of central agencies' jurisdiction over accounting, reporting, and financial management activities. This serious flaw will be discussed further later.

FINANCIAL MANAGEMENT STRUCTURE OF FEDERAL GOVERNMENT

The financial management systems of the Federal Government are actually a series of systems and subsystems that track its financial activities. Financial management of the Federal Government is concerned with budgetary and financial operations of both the individual departments and agencies and of the Federal Government as a whole. The appropriation is generally considered the primary accounting entity, with the department or agency considered the secondary accounting entity. The broad objectives of financial management in the Federal Government are set forth in legislation. The objectives are

- Full disclosure of the financial results of department and agency activities;
- Production of adequate financial information needed for department and agency management purposes;
- Effective control over and accountability for all funds, property, and other assets for which each department and agency is responsible;
- Reliable accounting reports to serve as the basis for preparation and support of department and agency budget requests to control the execution of the budget and to provide financial information required by OMB; and
- Suitable integration of department and agency accounting with the central accounting and reporting operations of the Treasury Department.

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To achieve these objectives ultimately and also to develop a much-needed modern, effective, and reliable federal financial management structure, sustained coordinated leadership from both Congress and the executive branch is the key.\(^8\)

**Standard General Ledger**

The Federal Government has recently adopted a government-wide standard general ledger chart of accounts. This is an initial step toward more standardization of the federal government accounting structure. It provides for a dual-track general ledger that provides for both "expense" and "expenditure" accounting and reporting. In other words, it provides for both budgetary and proprietary accounting within the same accounting structure. Chart 2 illustrates this concept.

**Accrual Accounting**

Federal departments and agencies are required by law to maintain their accounting systems on the accrual basis. In addition, departments' and agencies' accounting systems must provide information on obligations incurred and liquidated to assist in expenditure control, disbursement planning, and for reporting on the status of appropriations. This system is thus best illustrated:

- When an order is placed, an *obligation* is recorded;
- When the materials ordered are delivered, an *expenditure* is recorded;
- When the materials are used, an *expense* is recorded; and
- When payment is made, a *disbursement* is recorded.

Therefore, federal government accounting systems must include data on obligations, expenditures, expenses, and cash disbursements—not one basis of accounting over another.

Although there are statutory requirements for the Federal Government's accounting systems to adopt accrual accounting, there has been much noncompliance with the regulations. The reason for this is the overemphasis on the budget process within the federal government financial management structure.

Over the years OMB and GAO have been unable to agree on the benefits of accrual accounting data. Since OMB does not adopt accrual accounting in the budgeting process and because department

Chart 2. Federal Government Standard General Ledger
and agency managers focus on the status of their budgetary re-
sources, there has been no demonstrated need for accrual accounting
data in the current financial management structure. Congress has
consistently agreed with OMB on the lack of usefulness of accrual
data.

However, GAO reports that major commitments of federal re-
sources are only partially recognized in accounting and management
reports, since accrual accounting has not been fully implemented by
departments and agencies. Because they lack the authority to man-
date implementation of accrual accounting, the GAO can only report
the noncompliance. Until the Congress, OMB, and department and
agency managers find accrual data useful in the decision-making
process, full implementation of accrual accounting in the Federal
Government will proceed slowly.

**Fund Accounting**

As stated earlier, the reporting entity in the Federal Government is
generally the appropriation or the federal department or agency. How-
ever, fund accounting is also practiced in the Federal Govern-
ment. Two general types of funds are used in federal accounting:

- Funds derived from general taxing and revenue powers and from
  business operations: general; special; revolving; and manage-
  ment;
- Funds held by the Government in the capacity of custodian or
  trustee: trust and deposit.

**General Fund**

There is only one general fund in the Federal Government that has
a centralized cash account under the control of the Treasury Depart-
ment. Each department and agency general appropriation is treated
as a subdivision of the general fund with its own self-balancing group
accounts.

**Special Funds**

These are receipt and expenditure accounts established to account
for receipts that are earmarked by law for a specific purpose.

**Revolving Funds**

A revolving fund is credited with collections that are earmarked by
law to carry out business operations in which the government is the
owner.
Management Funds

These are funds in which there are merged moneys from two or more appropriations to conduct a common purpose or project, but not involving a cycle of operations.

Trust Funds

Trust funds are established to account for receipts that are held in trust in accordance with agreement or statute.

Deposit Funds

These are receipt and expenditure accounts established to account for receipts held temporarily and later refunded or paid to some other fund.*

The Federal Budget Process

The federal government budget process consists of four stages, as illustrated in Chart 3:

- Formulation of the executive branch budget;
- Congressional action;
- Execution of the approved budget; and
- Budgetary reporting and evaluation.

As required by law, the President is to submit the executive branch budget to Congress in January of each year. It is then the responsibility of Congress to consider the impact of the President's budget on the national economy and to establish federal fiscal policy for the coming year. To accomplish this task, Congress has developed a three-step process. First, Congress has an authorization process that establishes federal tax laws and creates federal programs to respond to national needs. The second step is the enactment of appropriations for each department and agency. Appropriations are not based directly on current expenditures but on authority to obligate the Government ultimately to make disbursements for expenditures incurred. Thus, department and agency appropriations are really their "budget authority." The third step is the congressional budget process. Under this process Congress annually establishes fiscal policy on how much total spending and revenues should be for the

Chart 3. Federal Budget Process

**Executive Formulation**
1. Program issues examined in agencies
2. Planning figures established
3. Initial fiscal policy assessment
4. Detailed estimates prepared
5. Revenue outlook updated
6. Office of Management and Budget
7. Presidential review
8. Submission to Congress

**Reporting and Evaluation**

*Reporting*
- By Office of Management and Budget
- By Congress
- By Treasury Department

*Evaluation*
- General Accounting Office

**Legislative Process**
1. Authorization process
2. Appropriation process
3. Congressional budget process
- Presidential approval

**Execution and Control**
1. OMB apportionments
2. Agency controls
3. Treasury disbursements
Government as a whole, and how total spending should be allocated among the major programs of Government.\(^\text{10}\)

**Impact of Computer Technology**

Computers have also played an important role in shaping the federal financial management structure. During the 1960s and 1970s computer technology carried the Federal Government into an era of large powerful mainframe systems that were capable of handling volumes of data and numbers of transactions far beyond previous capability. Without computers many parts of the Government could not function. During this period departments' and agencies' data processing expanded rapidly and continuously, with widespread extensions of their uses and capacities. Centralized organizations became the most feasible mode of financial management to adopt because of the data handling power of that generation of computers. Today, there are approximately 19,000 computers in the Federal Government. Many of these are outdated. The 1990s offer new opportunities through computer technology to change the financial management structure of the Federal Government. The technology of computers continues to change rapidly and it is moving the financial management area from large centralized hardware-oriented systems to widely decentralized micro- and minicomputer systems designed to meet the needs of individual users.\(^\text{11}\)

**FINANCIAL REPORTING**

If federal managers are to fulfill their responsibilities, they must have the information and resources necessary to function and to manage the affairs of government. In addition they must demonstrate through the financial reporting process their financial responsibilities. Federal government managers generally lack the following type of information that is used for analysis and decision-making purposes:

- Cost information;
- Periodic summary performance reports of budgeted versus actual expenditures;

\(^\text{10}\)The Congressional Budget Process (cited in fn. 5), p. 1.

• Periodic financial statements for each department and agency and the executive branch as a whole; and
• Key statistics needed for analysis.

It is apparent that the current financial reporting process does not provide reliable, timely, and consistent information for policy formulation and management control.

The reason that there are no performance reports of budgeted versus actual expenditures can generally be attributed to the lack of integration between the budget formulation process and the accounting/budget execution process. The budget is prepared at the program or activity level, whereas department and agency accounting systems generally collect information at the organization/appropriation level.

Therefore, there can be no reporting of budgeted versus actual expenditures because the data are accumulated at different levels. Until the budget formulation process is integrated with the accounting/budget execution process and data are captured at the same level, this situation will continue to exist. With the rapid advancement of computer technology today and a desire on the part of management and the Congress, there is no reason why this integration cannot occur in the near future in the Federal Government.

As for the issue that the financial reporting process does not produce reliable and timely data, this can be attributed mainly to the antiquated and fragmented financial management systems employed by the departments and agencies. Since most departments and agencies are very large and their operations usually expand around the world, this factor is important.

Another contributing factor is that there is no strong centralized financial management function in most departments and agencies, which results from a lack of coordination as well as a lack of strong leadership by management to ensure that financial reports are produced in a reliable and timely manner. Possible solutions to this problem could be a program to modernize and upgrade the Federal Government’s financial management systems as well as legislation to create a chief financial officer for the Federal Government (discussed below).

Financial reporting within the Federal Government generally revolves around central agencies’ (OMB, Treasury) reporting requirements, which focus on obligations, cash receipts, and disbursement data. Although department and agency managers determine their own reporting needs, that information generally relates to their status of funds or appropriation balances. The financial reports of the Federal Government include
• OMB requirement—report on budget execution. This monthly report is submitted by departments and agencies to OMB reporting on the status of budgetary resources by appropriation.

• Treasury requirements—statement of transactions: This monthly report is submitted by departments and agencies to Treasury reporting on their monthly cash transactions by appropriations. Year-end closing statement: This annual report is submitted by departments and agencies and reflects the official financial results of appropriation balances in terms of available budgetary authority. Managers are required to certify the information on this report. It serves as input to the President's budget document as well as the annual report submitted by the Secretary of Treasury to Congress. Business-type financial reports: These reports are generally prepared annually by departments and agencies. Their focus is on the department or agency rather than on the appropriation level. They are prepared on an accrual basis and include report on financial position and related schedules (report on operations), report on cash flow, and report on reconciliation.

    Treasury also has financial reporting responsibility for the operations of the Federal Government as a whole. The principal reports include the daily statement of the U.S. Treasury; the monthly statement of receipts, expenditures, and balances of the U.S. Government (the input for this report is from the statement of transactions monthly report submitted by departments and agencies); combined statements of receipts, expenditures, and balances of the U.S. Government (this is the Secretary of Treasury annual report to the Congress as required by law); and consolidated financial statements of the U.S. Government (the input for these financial statements is the business-type financial reports submitted by departments and agencies that are prepared on an accrual basis).

• GAO requirements—The accounting principles and standards issued by the GAO require four basic financial statements to be prepared annually. They are statement of financial position; statement of operations; statement of changes in financial position; and statement of reconciliation to budget reports.

    Department and agency compliance with the GAO reporting requirements is extremely low. Agencies are more concerned with complying with the central agencies’ (OMB and Treasury) requirements, because information provided to the central agencies is used for analysis and decision making relating to the Federal Government as a whole, whereas the GAO reports are prepared generally for financial
audit purposes, which does not occur in most departments and agencies.

MAJOR PROBLEMS WITH CURRENT FINANCIAL MANAGEMENT STRUCTURE

One of the most pervasive problems of the Federal Government today is its inadequate, unreliable, and untimely financial information. There is universal agreement among government financial leaders, professional accounting organizations, and others that the Government's financial management structure needs strengthening. A wealth of data from various studies addressing these problems is simply not being used because the Federal Government generally lacks the will and the capacity to agree on and implement the needed reform. Recent reform efforts highlight the fundamental fact that the Government suffers not from the failure to diagnose its problems, but from a failure to implement real change. It is rare to find political leaders who have the experience and motivation to spend part of their precious time in attempting to deal with the basic problems associated with the current financial management structure.12

This is not to say that Congress and the President have been idle in confronting the significant financial management problems with the current structure. On the contrary, the list of their various initiatives is very impressive but is only a beginning in the reform effort.

Identified Problems

The major problem with the current federal government financial management structure is that the federal budget process creates management disincentives. It is unrealistic, inflexible, and simply unnecessarily burdensome. It is forced to become an allocation of scarce resources, which in turn heightens political conflict and places greater strain on the process itself.13 The annual budget cycle forces managers to focus on short-term goals rather than long-term initiatives, which has led to poor management policies and practices. The real world is certainly not a one-year world.14 The budgeting process is a formalized, stand-alone process that often ignores decisions or crowds out activities in other areas of financial management.

There is also a primary emphasis on fund control. The historical and continuing emphasis on fund control has hindered the integra-

12Ibid.
13Ibid., p. 17.
tion of budgeting and accounting and has led to inadequate attention to other areas of financial management. Because these systems are not integrated, budgets are generally developed without reliable accounting data.

The poor quality of the financial management information is another problem. Today’s financial reports provide a flood of information that is usually inconsistent, incomplete, unreliable, and untimely.

Inadequate attention is paid to monitoring and comparing budget activity with actual results. Because budget formulation and execution systems are not fully integrated, the budget’s usefulness as a management tool is reduced. It is difficult to compare budget authority granted by Congress with actual results.

There is inadequate disclosure of assets, costs, and liabilities. Major commitments of federal resources are only partially recognized in accounting and budget reports.

The old financial management systems of the Federal Government cannot support the new demands being placed upon them. Many systems employ outdated technology and equipment and are not designed to provide the information needed by management in today’s world.15

Overemphasis on Budget Process

The problem areas that contribute significantly to the decline of the federal government financial management structure are the first two areas mentioned above. They deal with the budget process. The overemphasis that has been placed on the budget process over the years has created a real financial management structural problem. Also, the lack of discipline within the financial management systems and by management that is highlighted by the large deficits incurred by the Federal Government has contributed to this problem. Some people believe that a constitutional amendment to require balanced budgets would provide the missing discipline in the process. However, with the democratic form of government of the United States, it is healthier when budgeting decisions can be made through open legislative debate and action rather than mandated by legislation.16 The


concept of biennial budgeting could be a start toward streamlining both the budget formulation and the execution process.

Chief Financial Officer

Another concept that would greatly assist in bringing about financial management reform is the proposal to create a chief financial officer of the United States. No major corporation should be without a strong centralized financial management function. An independent chief financial officer would provide the needed focus and coordination in the Federal Government. Without a single authoritative source for federal management policy, the critical gap or missing link would still exist in the financial management structure. A single organization has to be responsible for directing and carrying out the Government’s financial management functions instead of the current structure in which the responsibility is shared by the central agencies.

Conclusion

The Comptroller General of the United States, Charles A. Bowsher, has best summarized the problem. He stated that for financial management reform to be most successful, an integrated approach must be taken for developing a comprehensive financial management structure. The changes should be government-wide, serving the needs of both Congress and the President, and ensuring that consistent financial data are available across departments and agencies and boundaries. Implementing this new structure and making it work will require new systems that implement proven financial management concepts and that will take advantage of the latest in technology. The time has come for the Federal Government to demonstrate that it has the will and capacity to agree on and implement the needed financial management reform.

Government Accounting and Financial Management in Latin American Countries

JAMES P. WESBERRY, JR.

AN OVERVIEW

Public sector management in Latin America has many deficiencies and most of these are found in government accounting and financial management. While accounting for government is not a priority in many countries, in Latin America it appears to have been accorded the lowest possible priority—for several reasons.

First and foremost, the accountancy profession is weak in most Latin American countries and commands little respect. Few talented young people therefore seek to enter it, thus perpetuating its weakness. In the private sector most businesses are family owned or closely held. Accounting records are limited to those necessary to run the business and to furnish tax information, which are not necessarily the same. There are few reasons for public disclosure of financial information or for its independent audit. Accountancy has thus been very slow to develop and is not held in the same high esteem as in some industrialized countries. Since private sector accounting is weak, public sector accounting is therefore far weaker.

Second, public sector financial management in general in Latin America is lax and rarely professional, partly owing to the low priority it receives. Among the various financial management functions, accounting is given even lower priority. Government accountants are often not really accountants but persons given posts through contacts, who learn the existing practices on a repetitive basis without understanding them or having the capacity or desire to improve them. Sometimes bright young people may hold a clerical accounting post at the beginning of their careers while attending college, but they are unlikely to continue in the accounting field as it lacks challenge and opportunity.
Third, government accounting is completely overshadowed by the budget function in most Latin American countries. Priority and emphasis are placed on budgeting. Foreign technical assistance is often received only for budgeting. Budget offices frequently maintain their own separate accounting records, which are more accurate, timely, and useful than those of the accounting offices. National treasurers’ offices often do the same. In such cases the national accounting offices, where they exist, tend to become appendages that reduce unemployment more than manage the government. In some countries public entities do not have accounting units—whatever accounting is done is performed by treasury or budget units.

Finally, government accounting in Latin America is so poor in quality, inadequate in content, and late in presenting data that no one pays much attention to it. It serves primarily the legal purpose of documenting and summarizing receipts and expenditures in a formal report that is presented several years after the execution of the transactions reported. Since government accounting itself is of such limited use, it cannot hope to merit priority for improvement, nor can it attract competent staff.

All the above factors may have contributed to the continuing economic instability and constantly recurring external debt crises that the Latin American countries experience.¹

A better perspective of these issues can be obtained by considering the historical development of the systems in Latin American countries, which for the most part were influenced by the Spanish heritage. Brazil, which had a distinct Portuguese heritage, however, had several common characteristics with other Latin American countries.

HISTORICAL DEVELOPMENT

Many of the characteristics of government, government accounting, and financial management in the Latin American countries are of course derived from the heritage bestowed by colonial governments in the distant past, by influential neighboring countries over the years since independence, and by multilateral and bilateral donor organizations in more recent decades. Under the Spanish system brought by the conquistadores to the new world, an accountable officer, called a

¹Government accounting in Latin America was described by its own practitioners in a workshop held in late 1988 in similar terms. See, for example, U.S. Agency for International Development (AID), Improvements Needed in Managing Public Resources in Latin America, report of a workshop sponsored by AID, Miami, Florida, December 6–8, 1989, pp. 14–16.
rendente or cuentadante, responsible for financial and/or physical resources, was required to safeguard them physically, handle all transactions, maintain all records, and periodically present an account or rendir cuenta before a formally established legal authority known as a court of accounts or tribunal de cuentas. This system or equivalents thereof was practiced by most European countries, including Great Britain, over the centuries. In effect the accountable officer was responsible to the king for certain resources, and the court of accounts acted on the king’s behalf to assure that a proper accounting was made.

After independence the Latin American countries retained the courts of accounts, which were generally made responsible to the parliamentary bodies. The system in which an individual accountable officer acted as resource manager, custodian, and accountant continued. Accounts were formally presented by individuals who were solely and personally responsible for them and were judged by the courts of accounts on behalf of the state.

As governments grew in size and complexity, the system of presentation of individual accounts became untenable. Just as the concept of the corporation as a fictitious but legal entity grew to be accepted in commerce, the concept of the governmental entity gradually evolved. Learning from its private sector experiences, Great Britain had abolished the court of accounts system in favor of entity-based accounting supported by independent audit and the United States inherited this system; however, it too retained the concept of the individual accountable officer responsible for receipt, custody, disbursement, and accounting until the early twentieth century.

Major changes were made in the U.S. accountability systems in 1921. Within a few years these spread to the Pacific coast countries of Latin America through the Kimmerer Commission, one of the first U.S. efforts in international technical assistance. Working with several Latin American countries in the 1920s and 1930s, the Kimmerer Commission implanted numerous institutions on the U.S. model, including central banks, social security systems, and, in the area of governmental accountability, comptroller generals’ offices. The first comptroller generals’ offices were modeled closely on the U.S. General Accounting Office, which had been established in 1921 to provide central accounting for the U.S. Government. Several other Latin American countries that the Kimmerer Commission did not visit later adopted similar systems. All of these systems still retained the concept of the individual accountable officer who now presented accounts to the comptroller general for verification as to legality and regularity. Accounts and all supporting documentation were physi-
cally presented to the comptroller general's central office for review there by staff members. This system continued both in the United States and in many Latin American countries during the 1930s and 1940s. The Atlantic coast Latin American countries and the Central American countries continued to maintain the court of accounts system during this time. Mexico set up a Comptroller General's Office at one point, but it did not function on the U.S. model and was abandoned, to be re-established later in a rather unique manner.

After World War II the United States was forced to make drastic changes in all its financial management systems to cope with the vastly expanded scope and volume of public sector activities. The same happened in many Latin American countries, but many of them delayed financial management reforms until later, preferring to persist with traditional systems.

All but one of the Central American countries exchanged their court of accounts system for comptroller generals' offices during the 1950s to 1970s. Several Latin American countries also initiated sophisticated attempts to utilize electronic data processing in financial management during this time; however, most processing was limited to payrolls and other specific isolated applications.  

The result of this evolutionary process has been that at the beginning of the 1990s quite a diversity of approaches was used by the various Latin American countries in government accounting and financial management. A few countries still maintain the court of accounts system, usually highly modified and adapted to their own experience and needs. Many countries have comptroller generals' offices, but the functions of these offices vary considerably from country to country. Some comptrollers general are deeply involved in precontrol and accounting while others limit their activity to external audit. Some comptrollers general are required by law to perform only

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2Since the 1950s international and bilateral donor or lender organizations have made technical assistance available to the Latin American countries in many areas, including government financial management. There has been little or no coordination among the donor organizations. Much of this assistance, especially at the beginning, concentrated almost exclusively on developing the budget system. Little attention was given to accounting, and none to cash and debt management. Some countries received considerable assistance while others received little. Most attempts to improve public administrative systems failed during this period, including those in budgeting and financial management. As a result some donor organizations became reluctant to continue technical assistance to improve public administration in the developing countries. During the 1970s few major efforts to improve government financial management were considered by the donor organizations. Some specific short-term technical advisory services were made available by some international organizations. Only in the late 1980s has there been a reawakening of interest by the donor organizations to the need to modernize central government financial management.
nonfinancial functions that have no relationship to their audit func-
tion.

Most countries have adopted, at the urging of international agen-
cies, sophisticated systems of program and performance budgeting. Unfor-
nately these systems have not produced the desired results. Little has been done in government accounting and cash and debt
management until very recently. The external debt crisis since 1982
has focused attention on determining the extent of, and controlling,
external debt. Some countries have implemented microcomputer-
based debt management systems, but again isolated from the other
financial management systems, as they were when budgetary sys-
tems were improved.

Cash availability clearly dictates the priorities of public spending
today. Since many major expenditures are “uncontrollable” or practi-
cally so, governments and donor organizations are realizing that cash
management is perhaps the most important component needing re-
form, and first attempts have been initiated in at least three countries
to improve simultaneously all the financial management systems on a
coordinated and integrated basis.

No country in Latin America may be considered to have a model
accounting or financial management system. Inflation has made most
budgetary systems superfluous. Cash flow forecasting is practically
unknown. External debt poses an insoluble problem. The urgent
need is to determine what strategy might work to improve govern-
ment financial information quickly and assure its availability on a
timely basis. Even with such a strategy, however, the resources to
provide the dramatic improvements needed are not in sight. In Latin
America, as elsewhere, true financial management reform only comes
about in the aftermath of extensive internal scandals and/or catalytic
external events that lead to complete economic collapse. It may be
reasonably concluded therefore that the chances for such reform are
improving.

INSTITUTIONS AND THEIR ROLES

A “Typical” Latin American Government Financial
Management System

At the outset it must be admitted that there is really no such thing
as a “typical” financial management system anywhere. What will be
described in this section are some of the features commonly found in
several Latin American government accounting and financial man-
agement systems at the entity and central levels. Those aspects of
Latin American government accounting and financial management

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that are considered "different" or "unique" compared with similar functions in the industrialized countries will be especially highlighted.

Central Government Accounting

Our fictitious "typical" Latin American Government would have the central government accounting function located in the finance ministry but not at the level of an undersecretary, as it might be in regard to budgeting, public debt, and even sometimes treasury. In late 1989 one Latin American country set up the first undersecretariat for government accounting. A directorate or general directorate of government accounting is normally responsible for prescribing accounting requirements (normally not called principles or standards) and for centralizing the accounting information reported to it by the various ministries and other entities of the central government. Such information would normally be required on a monthly basis but would arrive between three and nine months after the close of the month reported. It would consist primarily of a summary of expenditures made during the month being reported, in addition to directly collected revenues, if any. In a more sophisticated system it might consist of a monthly summary of transactions in the form of a trial balance showing amounts budgeted, allotted, committed or obligated, and expended, together with balances available for future commitment or expenditure.

Some countries also centralize information on assets, liabilities, and net government equity from reports filed by ministries and other entities but rarely is this information complete, consistent, or useful. In a few countries the comptroller general’s office receives and compiles the centralized information. In any case the centralized information cannot be reported until all or nearly all entities have made their reports, and it is often not available until a year or so after the close of the month being reported.

Curiously, a typical central government accounting office records the summarized monthly information received from the entities in double-entry accounting records consisting of a general journal in which summary entries are recorded and a general ledger to which entries are posted. This is done even though no real original transactions are recorded, only summaries of transactions originally recorded on a single-entry basis in the entities. In this manner governments pay lip service to requirements for double-entry accounting without receiving any of the benefits that it provides.

Since monthly information is received, recorded, and summarized far too late to be useful, monthly reporting, which is useless anyway,
is not carried out. At year-end the annual information accumulated, when finally complete, is published in great detail in a formal report to the Parliament, which is presented about two to five years after the end of the year being reported and is totally disregarded except when occasionally used as a source of historical information.

Thus, in our typical government accounting system the centralized accounting information serves no useful purpose whatsoever. The central accounting office has therefore no prestige. The accounting staff positions are awarded to individuals who, without any accounting credentials but with considerable recommendations from appropriate persons, need employment and therefore obtain it.

While the foregoing may be typical, a few “atypical” countries exist that produce relatively timely monthly and annual summaries of revenues and expenditures based upon a similar system that incorporates sufficient discipline to provide fairly timely data. In addition, the very small countries (both geographically and in terms of volume of financial transactions) are highly centralized, thus avoiding the necessity of centralizing information from decentralized entities by processing all transactions through the central treasury and recording them in the central accounting records.

Returning to our typical country, we must complete the description of what happens when the accounting information is usually produced very late. The national budget office, located in the finance ministry, normally maintains a single-entry accounting system in which all expenditure transactions or summaries thereof are recorded. While these data may not be completely on time, they are invariably more so than data from the accounting office, and thus become the source of whatever internal information is actually used in managing the government.

For cash management purposes, the central treasury office maintains a duplicate set of single-entry records of revenues deposited, classified by source, and of disbursements made, normally not classified by budgetary categories. Some treasury offices maintain cash basis, double-entry accounting records. In the worst cases, where few, if any, records are kept, cash flow information is simply obtained from the central bank.

Typically, the central accounting office located in the finance ministry or the comptroller general’s office prescribes through directives, regulations, or some formal process the requisites for entity accounting to produce the information to be reported monthly for centralization. It may prescribe standardized reporting formats or forms and usually prescribes standard account classifications.

The major difference between government accounting in Latin America and accounting in most of the industrialized countries lies in
the segregation in Latin America of "budgetary" accounting and "patrimonial" or equity accounting. Completely separate records are maintained for "patrimonial accounts," which include assets, liabilities, and government equity. These accounts are considered minor, are incomplete, and are rarely used. Fixed asset information may be excluded altogether, understated owing to partial reporting, or overstated owing to failure to record assets retired from service or disposed of.

Often a separate office is established to record and control acquisitions of supplies and fixed assets in a manner completely isolated from the accounting office and the accounting system. Such offices usually expend considerable resources taking physical inventories but are unable to devise means of updating data for asset acquisitions and retirements and thus immediately lose control of the assets for which they are expected to account.

Only a very few Latin American countries are considering the application of modern accounting techniques to produce timely and useful information for use by management. 3

Other Central Government Financial Management Functions

Usually the central budget, debt management, and treasury functions are located within the finance ministries of the Latin American countries at the level of undersecretariats or general directorates. The auditing function is typically located in a comptroller general's office, which is usually responsible to the legislature, though at least four countries still maintain a court of accounts. One country has set up at the cabinet level a secretariat of controllership, which oversees the internal audit function in the government in addition to a separate legislative audit function. Few Latin American countries have followed the U.S. model of locating the budget function in the Presidency.

The typical Latin American national budget directorate or undersecretariat operates under the authority of an "organic" or fundamental budget law that sets out the budget responsibilities, methodology, and process. The program and performance budget methodology long recommended by the international donor community is normally set out in this law. The central budget office is responsible for coordinating the budget with the national planning ministry or

1A number of countries may have been affected by poorly conceived and delivered technical assistance offered by well-meaning but incompetent organizations that have furnished technical advisers and instructors not professionally qualified as accountants or inexperienced in modern government accounting, thus further complicating the task of improving government accounting and financial management.
agency, establishing the budget formulation process, setting the financial parameters (including the revenue estimates), providing and communicating the budget calendar, obtaining agency expenditure requests, providing financial analysis, compiling the budget document, and submitting it to the minister of finance for presentation in turn to the executive and legislative branches of the government.

The typical organic budget law provides a model budgetary formulation process including bottom-to-top participation by the public entities. In practice the budget process is highly centralized with little if any input by the operating agencies. The national budget office typically proceeds to formulate and recommend the budget without much regard for the requests submitted by the entities—which are traditionally unrealistically high in anticipation that they will be drastically reduced in the budget review process. Time and resources often do not permit realistic budget review, and the annual budget is primarily prepared based on the previous year’s budget adjusted incrementally for those expenditure increases or decreases desired by the executive as well as for the estimated effects of inflation.

Budget proposals are rarely available for legislative consideration before the beginning of the year and the annual budget appropriation law is often approved long after the year has begun. There is usually a long delay between the adoption of the annual budget law and the issuance of spending authorizations so that it may well be beyond midyear before the budget is actually in operation. During the first part of the year expenditures are commonly limited strictly to salaries of employees and any government operating expenses that are absolutely necessary. Discretionary expenditures normally occur therefore in the latter part of the year, especially when delayed further by cumbersome competitive acquisition requirements. Major discretionary disbursements will often actually be made in the following year. Because of these delays some governments hold their budgetary books open well into the next year to record the disbursement of funds that were planned to be spent in the previous year. Thus two or more separate parallel budget and accounting systems may be maintained for two or more years depending upon the delays accepted. The effects upon sound financial planning, budgeting, and accounting are of course devastating.

Cash availability in reality drives the entire budget expenditure process in the Latin American countries. In recent decades only a few Latin American countries—those blessed with petroleum—have experienced periods of relative ease in raising revenues sufficient to finance their expected expenditures. Since the beginning of the external debt crises in 1982 all countries have been subject to recurring cash shortages in relation to planned and budgeted expenditures.
The pressure to maximize the use of available cash is gradually causing interest in improved cash forecasting and management; however, few real reforms have yet been made. The typical national treasury office still performs only routine "cashier" functions for the government, leaving cash management, if there is any, to the central bank. Large amounts of idle cash funds are typically on deposit in the accounts of autonomous entities and in "special bank accounts," often outside the budgetary and accounting systems, even in periods of the most dire need for cash to pay basic recurring government costs.

The shock of the debt crisis has caused many Latin American countries to turn attention to managing debt, or at least external debt. With the help of international donor organizations many countries have established controls over existing external debt and the incurring of new debt. These new debt management systems have usually been set up separately from the existing budget, accounting, and treasury functions and cause therefore further disintegration of the financial management system. Debt management is rarely considered an integral part of cash management. Long-term government cash flow planning, including the systematic planning of needs for external financing, does not normally exist.

The proliferation of public corporations and other autonomous or semiautonomous entities outside the normal central government financial management system has resulted in the exclusion of major portions of public sector financial resources and debt from the financial management process. This situation has often been justified by the cumbersome central financial management process, but it has created more problems than it has solved. In recent years many Latin American Governments have been experimenting with ad hoc mechanisms for regaining control over these autonomous entities, often creating yet another layer of bureaucracy in the financial management process and further acting to disintegrate government financial management. Financial management of the public corporations has sometimes been better than that of the central government, but it appears to deteriorate over time even in the best cases.

In summary, the Latin American central government budgeting, cash, and debt management agencies do not function efficiently. Only budgeting has been highly developed in theory, but it has not worked in practice. Cash management is an abandoned area, and debt management only newly discovered. Isolated approaches to improving these areas as well as accounting are the rule rather than the exception. Only one country has established a central coordinating function intended to assist in the integration of the government’s financial management systems. Only one country has a unified organic law
that governs all aspects of financial management in its public sector. Only two countries have attempted to unify and coordinate all secondary provisions relating to public sector financial management, including the issuance of standards, policies, and other measures on a coordinated basis.

Entity Accounting and Financial Management

Most Latin American government ministries, departments, agencies, and enterprises are bewildered by the still confused concept of the individually responsible "accountable officer" or rindente and the modern need for managing the organization as an entity. Many countries have not recognized each government ministry and agency as an accounting entity responsible for its own financial management through its own chief executive officer. Legal systems continue to exclude the chief executive officer from financial responsibility and hold only each accountable officer responsible for those resources under his direct responsibility.

The modern concept of internal control is largely unknown or unrecognized by most governments, especially in legislation and organizational arrangements. Thus the financial management of entities is largely disintegrated. Responsibilities cannot be clearly fixed in such circumstances, and the entire process foments irresponsibility and irregularity. In effect, the old system of presenting individual accounts is obsolete and inoperative and a new system has not yet replaced it in many countries. Most countries have initiated piecemeal attempts to improve on the old system, often paying lip service to modern techniques. But the modern techniques have rarely been sanctioned by law, and antiquated legal provisions and regulations based on them often maintain entity financial management in a straitjacket. All of this, of course, obviates the possibility of applying modern managerial techniques and holds the entire public administration hostage to obsolete tradition embodied in unchangeable law.

Where attempts have been made to modernize financial management laws the parliamentary bodies (largely composed of legalists in the old tradition) are reluctant to make the breaks with the past that are necessary. Politically based charges are often made that new and modern techniques seek ulterior motives, and where these allegations prevail, financial management reform becomes impossible.

The real victims of stagnated financial management legislation and regulations are the persons responsible at the entity level for making government work. Some years ago in one Latin American country a procedural flow chart was developed showing all the different processes, paperwork, approvals, clearances, documentation, recording,
and handling of a single financial transaction in one entity from beginning to end. The flow chart was 17 meters long! Innumerable public officials at various government levels intervened in the process, inevitably registering their approval or clearance and requiring copies of documentation. That flow chart convinced the government to modernize its transaction process, eliminating various layers of false controls and useless approvals and clearances. This case was perhaps extreme but many entities could well measure the delays in the bureaucracy of financial transaction processing in meters of flow charts.

The major problem that entities experience results from the fact that they are rarely delegated the authority to carry out the programs for which they are responsible. The existence of innumerable well-intentioned external checks and controls makes efficient execution impossible.

The typical central government entity in Latin America, following the lead of the central government itself, places a low priority on financial management, and accounting is considered an unnecessary evil. Because numerous external controls are imposed on all transactions, entity management takes the attitude that financial management is really an external function that can be handled between the accountable officers and the central financial organizations. Management therefore assumes no responsibility for financial management or control within the entity. If irregularities occur, they are the problem of the accountable officers and the central officials, not of entity management.

Curiously, the accountable officers often claim that they go to jail or otherwise suffer for simply carrying out the orders of the higher-level officials who are excluded from responsibility. Another curiosity is that, notwithstanding all the external controls and legal requisites that are commonly blamed for the interminable bureaucratic delays in processing financial transactions, when the entity chief executive orders some specific transaction to be carried out immediately—especially one of interest to higher levels of government—a way is found to process that transaction speedily. Without this possibility, of course, government could not operate at all.

In the typical entity the principal financial official is the paymaster or cashier, who is often responsible for making disbursements in cash or for drawing checks and distributing them. Each entity often has a number of separate paymasters. They deal directly with central treasury offices, bypassing the entity accounting system. If the entity has significant self-generated revenues, a special-purpose revenue collection or treasury office may handle them, including single-entry de-
tailed accounting by revenue source. If collections are minor the paymaster may handle them.

Employee salaries are typically handled exclusively by the personnel department, including all checks and verifications on eligibility for pay and hours or days worked. These departments usually deal directly with central data processing offices that likewise bypass the entity accounting system. Acquisitions of goods and services are subject to specific legally mandated procedures that are administered by a designated acquisitions department but are often subject to numerous controls outside the entity that are likewise handled by bypassing the accounting system, which thus cannot obtain information on the status of expenditure commitments until long after they have been made.

Since the accounting department is usually understaffed by unqualified clerical employees of low status and pay and has little access to financial data on transactions, it is often reduced to maintaining a historical record on a cash basis of transactions long since made. Emphasis is placed on the historical recording of receipts and disbursements of cash, not on their classification according to budget category. Sometimes goods and fixed asset acquisitions are also recorded based on reports of expenditures made. Since there is no real pressure to produce the historical accounting data, accounting offices may produce only monthly, quarterly, or annual reports of global cash and resource balances and summary totals of transactions. No formal financial statements are prepared. All entity financial reporting is so late that the information could not be used for making managerial decisions if it was sought, and since managers are not accustomed to receiving such information, it is not sought.

Because accounting reports are so late and limited, those persons who need some form of financial data must devise ad hoc mechanisms for obtaining it. Usually the paymasters will maintain an ad hoc single-entry system for determining cash balances. Invariably budget offices will maintain an ad hoc system of budgetary accounts on a single-entry basis to control appropriations, allotments, monthly allocations, commitments, and final disbursements classified according to the official budgeted categories. These have become so institutionalized that in many countries "budgetary accounting" is considered the responsibility of the budget department.

In summary, since on an ad hoc basis the personnel office handles payroll accounting, the budget office handles expenditure-classified accounting (including data on the status of commitments received from the acquisitions office), and the paymaster handles global cash receipt and disbursement accounting and detailed revenue account-
ing, if applicable, it does not really matter whether the accounting office functions or not. It usually does not.

Entity accounting offices thus rarely generate data used in the entity. Their main role consists of furnishing finalized transaction summaries to the central government accounting office for it to consolidate. Since the accounting office does not in fact serve the entity, it is not strange that entity management considers it a low-priority unit and uses it primarily as a means of providing employment for persons who can find no other useful role in government but who are due to be employed.

Thus typical entity financial management is fragmented, information is partial and limited to that necessary to operate, and official accounting reports are late, useless to the entity, and used only for historical consolidation. In most entities there is no organized accounting system.

ILLUSTRATION OF A COUNTRY'S ACCOUNTING ORGANIZATION AND FUNCTIONS

The following presents the levels and functions of government accounting in the central government of a Latin American country recognized as producing timely, centralized financial data.

Entity Branch Office

Conducts detailed financial and patrimonial accounting (which does not include details of expenditures by budget category) based on single-entry records. Presents accounts to the entity accounting office.

Entity Principal (Regional) Accounting Office

Conducts detailed single-entry accounting of financial and patrimonial movements (does not include details of expenditures by budget category). Incorporates branch office accounting and consolidates transactions. Presents accounts to the national accounting office or, as appropriate, to the central entity accounting office.

Central Entity Accounting Office

Incorporates accounting reports of principal offices. Consolidates transactions of subordinate units. Presents accounts to the national accounting office.
Central Entity Budget Office

Conducts "budgetary accounting" (details of expenditures by budget category) on a single-entry basis. Presents budgetary movements to the national accounting office.

National Accounting Office

Conducts detailed accounting of national public debt. Accounts for national capital projects. Accounts for the execution of the budget and its integration with the financial subsystem. Incorporates accounting movements from accounts presented from other levels. Consolidates transactions among the subordinate units that present accounts. Determines the period's patrimonial results. Prepares the public accounts of the budget and of the treasury and of the balance sheet of the government.

INTERNAL CONTROL AND AUDITING

These two areas are discussed together owing to the dependence of modern auditing upon adequate internal control structures.

It should be obvious from the preceding discussion that the modern concept of internal control cannot exist in the traditional system in which the accountable officer is responsible for a multitude of functions, such as receipt, custody, disposal or disbursement, recording and reporting of resources given to personal and individual responsibility, without adequate segregation of these functions. Because many Latin American countries cling to the traditional system or to some modified version of it, internal control structures do not and cannot exist, nor can a modern audit system.

On the other hand a number of Latin American countries have initiated or implemented "national systems of control" that attempt to establish appropriate internal control structures including internal audit to permit the execution of modern systems based on government external audits. Their approaches have varied but some common elements persist. Several countries have prepared and promulgated government-wide standards of internal control and of professional government audit that usually include both internal and external audit. Several have also recognized through legislation the function of internal audit as a part of the internal control structure.

Also, a number have modernized the legislation governing their supreme audit institutions (usually offices of the comptroller general).

Unfortunately, progress in actually implementing sound internal control structures and professional approaches to auditing in Latin American Governments has been slow and disappointing. Some countries have made improvements only to fall back into old customs and procedures when the government or comptroller general changed.

The major problem in implementing sound internal control structures is that drastic modernization of the country's entire approach to financial management is required. Few major programs to achieve it have been launched, since they require extensive development and design of legislation, standards, procedures, and systems, and massive training efforts.

One major issue in this area involves the placement of responsibility for performing the precontrol function. This task, often miscalled "preaudit" in English, involves verifying the legality, propriety, actuality, arithmetic accuracy, due approval, budgetary authority for, and overall authenticity of, proposed financial transactions prior to their execution. Over the years many Latin American legislatures have imposed this function on the supreme audit institution, and some have established special units within the finance ministry to perform external precontrol. In extreme cases external control may be performed by all the central financial units (budget, treasury, and audit) and by other specialized units before a transaction is approved, first for commitment of funds, then again by the same process before disbursement.

Externally imposed precontrol poses three major problems and appears to solve none. The most obvious is the delay the outside approval process imposes on the completion of financial transactions. Second, external precontrol infringes on the authority supposedly delegated to heads of entities to carry out their duly authorized programs. It dilutes responsibility and results in a sense of false security by the entity, leading it to propose transactions that might otherwise be more closely scrutinized in the hope that they will be approved, since approval responsibility is in the hands of third parties. Most important, the external precontrol mechanism creates a new opportunity for corruption of public officials, because those outside the entity who must approve the transaction may be subjected to offers of payment to "speed up" the approval process. When such abuses become

Only one such activity has been attempted in Latin America without foreign financial assistance. Another recent effort was financed by several donors in a joint effort because of its magnitude.
institutionalized, there is a danger of a purposeful "slowing down" of the approval process to increase opportunities for, and amounts of, illegal payments to expedite transactions. Some Latin American public officials feel strongly that external precontrol serves only as a false security while it foments corruption and extortion. Others feel that entities cannot be trusted to carry out their duties honestly and must be subjected to strict external precontrol to protect public resources from abusive and unnecessary expenditure.

Obviously, an external precontrol structure, once institutionalized and even though apparently corrupt, cannot be dismantled until a corresponding sound internal control structure can be put in place. The modern tendency is to eliminate external controls in favor of stronger internal controls that are established at natural points in the flow of transaction processing and are applied by those individuals who normally process transactions, not by specially established groups or units. Such procedures seek to speed up the flow of transactions, minimize opportunities for corruption, and fix managerial responsibility within the entity. A few Latin American countries have successfully eliminated all vestiges of external precontrol. Most still have it in one form or another.

Some countries have concentrated efforts to improve internal control structures only for public enterprises and other decentralized institutions outside the framework of the central government. In these organizations internal controls have a stronger probability of success, especially where private enterprise managerial techniques and structures are used. Two countries have published internal control standards applicable only to decentralized entities.

There are several major problems in implementing modern professional auditing in central governments. The principal problem, of course, is the one mentioned above for internal controls. A modern, documented, auditable financial management system must exist. Furthermore, because modern audit must rely upon sound internal control structures to some degree at least, it cannot precede the modernization of internal control structures. The other major problem has been how to modernize supreme audit institutions that are steeped in traditional legal requirements having nothing to do with auditing and that compromise the independence of the audit institution as external auditor.

Quite a few Latin American countries have formally recognized in legislation the importance of a professional internal audit function in government. Those countries that have established "national systems of control" have placed emphasis especially on internal audit as a key component of such systems. Supreme audit institutions in several countries have strongly supported the expansion of internal au-
ditating, aware of its importance in fulfilling their own responsibilities. In a few countries, however, internal audit has been interpreted as synonymous with internal control, instead of being a key component thereof. They have attempted to hold the internal auditors responsible for the quality of internal control systems instead of the chief executives of the entities for whom the internal auditors work and to whom they should be responsible for evaluating, not implementing, internal controls. In a few countries, some confusion seems to have developed between the internal audit function and the supreme audit institution function in attempting to give internal auditors more independence, at times to such a point that the "internal" auditors are appointed by the supreme audit institutions and are responsible to them, thus becoming external rather than internal auditors. This situation in turn indicates the need for coordinated efforts to unify the criteria on the role of professional internal audit in Latin American Governments.

**STRUCTURE OF ACCOUNTING SYSTEMS**

**Fund Structure**

Fund accounting as known in English speaking countries is not practiced in Latin America. Attempts to transplant multiple-fund accounting in the U.S. state and local government model have failed in Latin America owing to its complexity and general inapplicability in the Latin American cultural context. Something similar to U.S. fund segregation has been accomplished by creating a multiplicity of autonomous and semiautonomous, off-budget entities of all descriptions by Latin American Governments. Normally the accounting entity in Latin America has a single general purpose fund. Trust and agency funds are not common. Where they exist and are recorded they are shown as liabilities.

**Basis and Coverage**

The cash basis of accounting is the standard in Latin American government. One country has legally established the modified cash basis, recording revenues when collected but recording commitments as expenditures when the liability to pay is established. Another country formally utilizes the accrual basis based on end-of-period adjustments, but day-to-day accounting is on a cash basis. "Budgetary" accounting records, which are usually maintained by budget offices, normally record budgetary appropriations, allotments, commitments, and disbursements, thus providing, for expenditures only, accounting on a commitment and a cash basis. Revenues are uni-
formly accounted for on a cash basis and estimates of accrued but uncollected revenues are rare.

Most original entry accounting at the entity level is recorded on a single-entry basis notwithstanding legal provisions and technical requirements for double-entry accounting that date back as far as the 1930s in some countries. Centralized accounting is often done on a double-entry basis to simulate observance of the double-entry requirements or to give the appearance of a formal accounting system.

Coverage of national government accounting systems is normally limited to the officially prescribed budget, in spite of the enormous amounts of public financial resource transactions that are segregated by special laws into off-budget organisms and "special accounts." At least one country has attempted unsuccessfully to expand its national accounting system to include all public resource flows of all types whether or not included in the budget. In many countries military and defense expenditures are maintained off budget and therefore outside the accounting system for national security reasons.

**Accounting Classification**

Traditionally revenue and expenditure classifications as prescribed in national budgets constitute those used in central government accounting systems. Since "budgetary accounting" is often carried out by budget offices, not accounting offices, government accountants are rarely consulted in establishing classification categories.

The use of sophisticated program and performance budget expenditure classifications has complicated the accounting process in some countries and has tended to make responsibilities for resource use unclear. For example, one country on introducing program budgeting in the 1960s established an excessive number of programs and subprograms and nearly 1,000 specific line-item expenditure accounts, each of which was theoretically applicable within each subprogram. The classification system was inoperable owing to the excessive detail.

In some countries complicated public employee remuneration systems have also complicated the budgetary and accounting classification systems through the creation of diverse categories of special types of bonus payments as well as "extra month" salary payments. For example, an employee might receive a total of 16 "monthly" salary payments during a year, each of which includes special bonuses for categories such as "exclusive dedication" (a prohibition on holding another job), "years of service" (seniority), "numerous family members" (more than a certain number of children), or for working in a difficult region. Instead of simply recording in the accounting
records the gross salary of each employee in these cases, attempts are usually made to include the entire detail of all bonus payments within the budgetary and accounting classification system so as to determine the impact of each type of bonus on the entire budget. As a result a vast number of unnecessary expenditure account categories have been created. The use of computerized payroll and accounting systems has made this type of detail feasible; however, where financial reports based on such detail are not summarized appropriately, they can be too voluminous and detailed to be useful.

The revenue classifications of some countries do not fully disclose or follow revenue sources while those of others are unduly detailed and complex. These classifications also become complex as a result of the practice of legislatively dedicating specific tax revenues for specific purposes and/or entities. Thus one single revenue source may be divided according to percentage deductions to 20 or 30 or more purposes or entities. Again while this practice is feasible, albeit unwise, where financial reports show such degree of detail, they tend to obscure the real purpose. The basic problem here is the tendency to utilize the official account classifications as the legally authorized format for financial reporting for all purposes, which is why many countries’ annual financial reports are so voluminous.

Unlike revenue and expenditure classifications, the classifications of assets, liabilities, and government equity are generally too simple and are inadequate for providing sufficient segregation of diverse types of assets and liabilities. This reflects the heavy emphasis on “budgetary accounting.”

A category of accounting classification unique to Latin America consists of memorandum accounts (cuentas de orden), which consist of a segregated group of self-balancing accounts in which formal entries are made to record and control minor items (such as officially numbered blank pages or unissued tax stamps). They are shown separately at the bottom of trial balances and balance sheets. They often disclose items that might otherwise be disclosed in notes to financial statements according to international accounting standards. Some governments record uncollected taxes and other revenues under this category to establish a form of accounting control while not recognizing them as revenue until collected.

Public enterprises similar to commercial enterprises often do maintain adequate accounting classifications but are sometimes criticized for not following the official government budgetary categories. In some countries they have been obliged to maintain a separate classification compatible with the official budget classification for expenditures.
Most Latin American Governments do not have integrated charts of accounts at the entity or national level that provide a comprehensive coding system for all possible financial transactions arranged on a logical basis for processing electronically to produce financial statements automatically from the accounting system.

**Management, Cost, and Public Works Accounting**

Few Latin American Governments have explored this area. One government has attempted to design and put into practice a cost system for the central government, but it has not been completed.

Public works accounting constitutes an important area, especially owing to major internationally financed development projects. The latter are normally stand-alone accounting entities with their own accounting systems supervised by the financing organization and maintained in accordance with its minimum requirements.

Where ministries or other large government agencies carry out internationally financed development projects the financing organization often requires the establishment of a special project administrative and accounting unit to handle all project accounting and financial management outside the regular entity financial management and accounting system.

The recording of fixed assets by national governments in Latin America is accorded a low priority and assets are rarely compared physically with accounting records. Fixed asset records are usually incomplete, undervalued, or nonexistent. Obsolete and fully expended assets rarely are removed from records once recorded. Governments periodically attempt nationwide inventories of assets, the cost of which seems highly questionable in the light of the failure to establish adequate accounting records and controls. Information reported on fixed asset values by central governments is dubious.

**Inflation Accounting**

All Latin American countries have been subject to inflation of varying degrees. As a result financial data from any two years are rarely comparable without adjustment. In a few countries hyperinflation has made comparability impossible even from one day to another. Most countries publish official indices that are used for adjusting historical values by private sector enterprises and by public enterprises as well. Central governments rarely use these indices in their accounting systems, although they may be used to adjust columns of comparative historical information in some financial reports. Because government financial reporting is not well developed in Latin Amer-
ica, government entities or central government accounting offices have not given much consideration to inflation accounting.

One of the best annual financial reports published on time by a Latin American Government presents a comparative ten-year summary of revenues and expenditures and a comparative three-year summary of assets and debt, both adjusted to current year values using the official index. No explanation is given of any inflation accounting techniques or adjustments. The financial statements for the current year, however, are not presented in comparative form, and no mention is made of the effects of inflation. Another country’s annual financial report, also issued on time and quite comprehensive in presentation, does not deal with inflation except that two tables are shown in “current pesos.” The official financial statements are not presented in comparative form and the “Notes to the Financial Statements” do not mention inflationary effects. The two countries cited have not recently experienced the severe inflation that many other Latin American countries have.

While most businesses in Latin America have had to adjust the values of historical asset acquisition periodically over the past few years, many governments have not done so, except for government corporations. Thus government-owned assets are often significantly undervalued, where they are recorded and reported.

Electronic Data Processing Systems

Large mainframe computer systems are used in Latin American financial management primarily for taxpayer records, payroll processing, and budgetary control over appropriations, allotments, commitments, and, in some cases, expenditures. Many large ministries have computer capabilities far beyond their human ability to put the computers to use. Few really modern computerized accounting systems exist. Those that do are usually for public enterprises not central government entities.

The lack of charts of accounts referred to earlier has prevented countries from taking advantage of the computer’s ability to reorder and restate information through preparation of financial reports based on the initial entry of properly coded transaction data.

Many obsolete or unneeded computer systems have been sold to Latin American Governments, sometimes financed by international organizations. Fortunately, the advent of powerful microcomputers

6Chile, Contraloría General de la República, Informe Gestión Financiera del Estado, Año 1988 (Santiago: Contraloría General).
7Colombia, Contraloría General de la República, Informe Financiero de 1988 (Bogotá: Contralor General).
portends the demise of large mainframe systems. But there is a real danger in the proliferation of noncompatible, obsolete, or uncontrolled microcomputers throughout governments. They should be a great blessing to Latin American Governments if they can be wisely used in carefully planned accounting systems on an entity basis. On the other hand, if accounting systems tend to become further fragmented so that different pieces of data are maintained in different uncoordinated offices, the microcomputer could doom all prospects for some governments of ever achieving adequate government accounting.

FISCAL REPORTING

As already indicated, Latin American financial managers tend to agree that the information presently produced by government accounting and financial management systems is "not acceptable." Only two countries appear to produce timely and comprehensive annual financial reports that may be considered useful to the users of government-wide financial information.

It would probably not be overly pessimistic to state that financial reports are rarely used in public sector management in Latin America—reflected in the continuing state of economic chaos and crisis involving internal deficit and external debt in most Latin American countries. The two countries that seem to have least economic and external debt problems are those two that publish timely and what appear to be reliable summary annual financial reports. Another characteristic that these two countries have in common is that the office of the comptroller general is responsible for overseeing accounting systems and centrally gathering and consolidating entity financial information into annual reports and in each country that office is strong, well financed, highly respected, and well disciplined.

Interim Reporting

For all practical purposes there are few, if any, interim accounting reports issued during the year in the typical Latin American government entity or central government. One may logically ask, therefore, how do governments and entities manage to operate? As noted previously, there are a number of unofficial, possibly unreliable, ad hoc reports or data summaries of financial information prepared outside the accounting system that furnish the minimum information necessary to keep government going.

Two basic types of information are indispensable to the internal operation of entities and governments: (1) data on availability of cash
to meet disbursement needs, and (2) data on the rate of expenditures compared with cash available and expenditures planned, usually in the form of comparative presentations of amounts budgeted and amounts expended. Alternate sources of information are sought to meet these needs.

Information on cash availability may be obtained direct from the central bank, in effect using the central bank's information system instead of the government's. Central banks can provide summary information on receipts deposited to government accounts and on checks for government funds drawn and paid. While this information is not complete (data on checks drawn but still outstanding are particularly lacking), it is better than none, and it is often what is used in central government financial management. In some countries the national treasurer maintains accounting records for cash transactions and is able to furnish interim information on cash availability, thus avoiding dependence on the central bank's records. Interim cash availability reports usually contain bad news, and their circulation is therefore limited to only a few key officials who must have these data.8

Data on expenditures compared with budgets should, in principle, be available from official accounting systems. Most frequently, they are not, but they are available from the entity or national budget that maintains its own "budgetary accounting system." This practice is generally accepted in many countries. Thus it is the budget office of the entity or the central government that produces interim financial reports used in ongoing management. One reason for this practice is that the accounting offices are so concerned with legalistically exact, detailed accounting that they are unable to close out their records on a timely basis each month to produce reports useful to managers.

Some smaller countries with highly centralized disbursement systems are able to provide monthly interim reporting of receipts and disbursements for the central government as a whole. Such data are rarely available early enough to be useful to management. One small country has a highly computerized system for "budgetary accounting" that is operated by the comptroller general's office and provides timely interim information on budgetary execution for the entire government.

Where interim reporting exists, it is normally not designed to meet managerial needs through summarization according to levels of responsibility. Data are typically reported in the maximum detail possible within the classification system. Managers responsible for specific

8These two sets of data may often not be reconcilable, particularly in regard to above-and below-the-line items of the budget.
programs who are conscientious are forced to maintain their own ad hoc records of commitments and expenditures to know the financial status of the activities for which they are responsible.

In summary, most central government and entity interim financial reporting is unofficial, limited to the minimum, and questionably reliable since it comes from outside the government’s systems or from ad hoc data accumulation systems.

Annual Reports

The main reason for the existence of the central government accounting offices appears to be the preparation of the annual general accounts (Cuenta General) or official financial report from the executive branch to the legislative branch of the government. This responsibility usually lies with the finance ministry, but is sometimes performed by the comptroller general. More typically the comptroller general’s role is to perform a legality and regularity “audit” (fiscalización) of the public accounts and present a separate report to the congress.

As noted above regarding the closure of monthly accounts, the tendency to ensure that all possible information has been recorded in exact detail in accordance with often archaic legal provisions results in very long delays in closing out the annual accounting records. The difficulty of achieving the discipline necessary to enforce timely presentation of annual information by the entities (especially the smaller ones) is a further complication. The low prestige of the accounting function and the low priority the government places on financial reporting contribute to an environment in which little attention is paid to deadlines for presenting information to the central accounting office. This problem appears to have been solved in only a few countries with extremely strong comptroller general’s offices, themselves responsible for central accounting, which enforce discipline in financial reporting.

Some of the smaller countries, particularly in Central America, have highly centralized financial management systems and do not face the problem of enforcing reporting by entities. They are able to produce more timely central information.

There is no generally accepted format for annual government financial reporting. Since 1977 various Inter-American Accounting Conferences have recommended that governments adhere to generally accepted accounting principles; however, few have attempted to do so. Only one has legislation requiring the entities and the government to present financial statements prepared according to generally accepted accounting principles (GAAP) and has promulgated such principles applicable to the public sector. Unfortunately it has been unable to
produce government-wide financial statements because most component entities still do not do so.

Several other Latin American Governments enumerate in their accounting manuals specific accounting principles to be observed, but none has concerned itself with financial reporting based on generally accepted accounting principles. Each government traditionally uses its own approach to the financial “statements” prepared, and often they bear little resemblance to the financial statements known to the accountancy profession. This practice is defended by those who contend that government is “different” from business and has little in common with it.

Government corporations in Latin America usually observe private sector generally accepted accounting principles as established within each country. Most issue annual financial statements and some issue annual financial reports including audited financial statements.

Quasi-corporate organizations owned by governments (often called “decentralized” entities to indicate they are not a part of the central government) have proliferated in Latin America. Where they are not clearly comparable with similar private sector activities, their accounting and reporting responsibilities usually follow the provisions set out for the central government, though sometimes they follow private sector generally accepted accounting principles or some combination of the two.

Most Latin American Governments recognize three major groupings of government entities:

- The central government, including the ministries and all other entities included in, and financed entirely by, the national budget.
- Decentralized entities, including independent agencies, government-owned corporations, universities, and “autonomous” entities, which may be fully self-financed from operating revenues, but most frequently are partially or principally dependent on budgetary transfers from the central government to finance their operations.
- Regional and local governments, which in many countries are financed fully or largely through budgetary transfers from the national government.

Based on the above or a similar scheme, Latin American Governments seek to provide annual financial information on a combined, though usually not consolidated, basis at each of the foregoing levels. Thus their centralizing accounting measures become extremely complicated owing to the problems of achieving uniformity to permit reporting. All countries have problems in enforcing timely reporting,
and all countries have gaps in data owing to the failure of some entities to report.

The traditional public accounts required by constitution and/or law in most countries usually contemplate only central government reporting. No country is known to achieve timely reporting of combined information at all three of the above levels.

**MAJOR PROBLEMS AND RECENT EFFORTS**

A number of major problems have already been mentioned. They may be summarized as follows.

- The professions that support public sector financial management in Latin America are weak, especially the accountancy profession. There are few established criteria or standards for government accounting, budgeting, cash and debt management, internal control, financial reporting, or auditing. Professional organizations, where they exist, are weak and in the case of accountancy groups, primarily concerned with the private sector. The financial management professions, especially accountancy, are not attractive to talented young people who might be expected to improve and strengthen them. Public sector financial management in Latin America is largely in the hands of nonprofessionals or weak professionals. The characteristically low remuneration scales in the public sector ensure the continuation of this situation.

- An underlying absence of discipline permeates government in Latin America. Proper accounting and sound financial management depend on a disciplined environment under the control of disciplined officials. Failure to observe the prerequisite of timeliness invalidates whatever other benefits accounting and financial management might offer. Discipline is demanded in the daily recording of financial transactions in such a way that they can be summarized and reported in a useful format. Most Latin American government accounting systems collapse at the very beginning of the accounting process because transaction data are not comprehensively captured and recorded adequately and promptly.

- The historical absence of useful and timely financial information has led Latin American public officials to learn to operate governments without it or with a minimum of ad hoc data (often unreliable estimates) acquired through any means possible. Officials have learned to expect nothing useful from government financial management, and they are not disappointed when that is what
they receive. Therefore it receives a low priority in public sector management, and the lowest priority of all the functions in financial management is given to accounting—the discipline that should be expected to process and provide all basic managerial decision data.

- Antiquated legalistic provisions and practices continue to prevail in most Latin American countries' financial management systems, obviating the possibility of utilizing modern techniques and technology. When modern technological equipment such as computers is used, it is most likely to be misused, increasing the cost of government without bringing tangible benefits to it.

- Approaches to reform of financial management systems in Latin America have been highly theoretical, concentrating primarily in the budget area, and have almost uniformly failed in practical implementation, causing them to be left in worse condition than they were in before the reform efforts were initiated.

- Latin American government financial management systems are fragmented and uncoordinated. Often those that work are extra-oficial or ad hoc. The different units responsible for budgeting, accounting, cash management, debt management, and auditing rarely communicate and coordinate their activities or share information. Each tends to set up its own information system instead of sharing and relying upon a single source and depository of financial data to which all contribute and in which all share.

- The modern managerial concepts of entity-wide responsibility through the organizational framework, accountability for resources and results, sound internal control structures, and the systems approach to planning, recording, processing, and auditing financial transactions cannot function within the straitjacket imposed by law, tradition, and irrational political decision making that characterize many Latin American Governments. The volume of financial transactions both in number and in value has caused the collapse of traditional approaches to public sector financial management. No rational framework has been able to replace them. Therefore almost all financial management data of Latin American governments lack reliability and credibility. Macroeconomic decisions must be based upon the best estimates, which could better be described as the best guesses.

- The extremely strong emphasis on central economic planning in the Latin American countries is dependent by its nature on a source of timely, reliable public sector economic data that have never existed in most countries. Thus central economic planning was condemned to fail from the start.

- The present chaotic economic situation that demands many se-
vere austerity measures of Latin American Governments makes it highly unlikely that any government will be in a position to improve the quality of its present financial management systems without massive external assistance directed to that end.

Initiatives to Improve Government Financial Management

There have been few real initiatives to improve government accounting and financial management in Latin America on the part of the governments and on the part of international donor organizations. Both groups fail to realize that such reforms must involve a long-term commitment.

Most initiatives to date have been limited in scope and duration. A typical reform effort, for example, might be to implant a program budgeting system in a period of 18 months. This type of initiative has failed repeatedly in Latin America because (1) it does not help to improve the budgeting system without making the necessary simultaneous improvements in accounting, cash management, etc., and (2) a short time frame measured in months does not permit the acceptance, adaptation, and durable implementation of the reforms proposed.

Most reform initiatives have involved either budgetary systems or audits by comptroller generals' offices. It has become abundantly clear that reforms in government audit capability not accompanied by improved internal controls leave auditors with little to audit. Time frames for reform initiatives typically involve periods of one to four years. Within five years after their conclusion, no evidence exists that they were ever carried out.

More and more governments and international and bilateral donors are coming to realize that financial management reform initiatives are long term, comprehensive propositions. The concept of the integrated financial management system (IFMS) is being proposed and accepted in some countries.

The first Latin American initiative based on the IFMS approach was carried out during the late 1970s by a country that relied upon its own resources and very limited external contracted technical advice. It produced a legislative and normative framework for an integrated financial management system and achieved limited implementation. Its major limitation was the failure to implement fully the reforms planned in the national accounting system.

A second IFMS initiative began in the mid-1980s in another country, primarily financed by international donor funds and based on considerable contracted external advisory assistance. Its results are not yet apparent. No other such initiatives are known to be under
way though one or two countries have expressed interest in the IFMS approach.

The development of an IFMS for the public sector involves a very long-term commitment of financial and human resources and, under present economic conditions, does not appear to be a viable approach in most countries using their own resources. Donor organizations likewise are reluctant to commit the resources necessary to develop an IFMS for a single country.

The most recent initiative to improve public sector financial management in Latin America has been the Regional Financial Management Improvement Project for Latin America and the Caribbean (LAC/RFMIP) initiated by the U.S. Agency for International Development in 1989. The project’s goal is to increase the ability of Latin American and Caribbean Governments to utilize and evaluate their scarce monetary resources more efficiently.