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Are we asking the right questions?

Embedding a medium-term
perspective in budgeting

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List of acronyms

BOP	balance of payments
BPR	business process re-engineering
CAEMU	Central African Economic and Monetary Union
CDF	Constituencies Development Fund
CIF	cost, insurance and freight
CTL	commercial transactional levy
DAC (OECD)	Development Assistance Committee (OECD)
EC	European Commission
ED	exposure draft
EDPRS	economic development poverty reduction strategies
ESAF (IMF)	Enhanced Structural Adjustment Facility (IMF)
EU	European Union
GFS	government financial statistics
GPRS	growth and poverty reduction strategy
HIPC	Highly Indebted Poor Country
IDA	International Development Association
IFMIS	integrated financial management system
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
ITAS	integrated tax administration system
LTO	large taxpayers offices
MDAs	ministries, departments and agencies
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
Mincombud	Ministers' Committee on the Budget
MINECOFIN	Ministry of Finance and Economic Planning (Rwanda)
MOF	Ministry of Finance
MOFEP	Ministry of Finance and Economic Planning (Ghana)
MTBF	medium-term budget framework
MTEF	medium-term expenditure framework
MTP	medium-term plan
NDP	national development plan
NDPC	National Development Planning Commission
NISR	National Institute of Statistics of Rwanda
OBL	organic budget law

ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
PBS	protection of basic services
P/DIS	pre-shipment / destination inspection
PEFA	Public Expenditure and Financial Accountability
PFM	public finance management
PPP	public private partnership
PRGF	Poverty Reduction and Growth Facility
PRSP	poverty reduction strategy paper
PSC	Parliamentary Service Commission
RA	revenue authority
RBM	Reserve Bank of Malawi
SBAS	strategic budget allocation system
SBS	sector budget support
SPA	Strategic Partnership with Africa
SSA	sub-Saharan Africa
STA	single treasury account
SWAp	sector wide approach
TAT	tax appeals tribunal
TRS	time release studies
URA	Uganda Revenue Authority
VAT	value added tax
WAEMU	West African Economic and Monetary Union
WCO	World Customs Organisation

Background

The Collaborative Africa Budget Reform Initiative (CABRI) held its fourth Annual Seminar in Accra, Ghana, from 13–15 December 2007. The seminar was hosted by the Ghana Ministry of Finance and Economic Planning. Representatives from 24 countries attended, most of them senior budget officials from treasuries, finance or planning ministries, along with representatives of various regional and international organisations. CABRI is a self-organising learning network of senior budget officials in Africa and has as a core objective the improvement of public expenditure effectiveness through enhanced public financial management systems.

It aims to achieve this through peer exchange and the development of common resources that speak to African priorities. The annual seminars are the highlight of the network's annual calendar.

The founding gathering of senior African budget officials took place in December 2004, hosted by the South African National Treasury. The seminar discussed key budget reform themes, such as budget credibility, multi-year budgeting and improving the quality of expenditure. The second seminar, entitled 'Managing Complexity: From Fragmentation to Coordination', was hosted by the Mozambican Ministry of Finance in December 2005. The meeting explored important areas of fragmentation in budgeting, such as the separation of recurrent and development spending, off-budget revenues and expenditure, debt relief, aid management and decentralisation. The theme of the third seminar 'Bridging the Gap: From Policies to Budgets' explored the disconnection between planning and budgeting systems in many African countries. It was held in November 2006 in cooperation with the Ethiopian Ministry of Finance and Economic Development and the UN Economic Commission for Africa.

The fourth seminar was titled 'Are we asking the right questions? Embedding a medium-term perspective in budgeting'. It brought together CABRI member country experience of overcoming systemic barriers to and establishing the right conditions and budgeting rules for effective medium-term budgeting. The results of the Aid on Budget study, commissioned by CABRI in collaboration with the Strategic Partnership for Africa, were also presented at the seminar, offering insight into how external development assistance affects sound budgeting and the good practices that are already emerging in member countries to bring aid better into the budget process. This book reflects discussions at the fourth seminar, outlining good practice, lessons learnt and the progress made in a number of countries.

1

Embedding medium-term perspectives

1.1 An overview

Alta Fölscher

1.1.1 Introduction

Since the mid-1980s, budgeting reforms worldwide have been concerned in a significant way with engineering a shift from planning and approving budgets for one year at a time to a multi-year perspective. The 2007 CABRI Annual Seminar took seriously network members' request to delve deeper into issues of medium-term budgeting.¹

Most CABRI countries have medium-term expenditure frameworks in place. Often these were introduced to engineer better alignment between policies, planning and resources. But almost as often, countries have found that the reform did not bring the promised benefits: leaving aside the de-linking of policies and resources that occur through weaknesses in budget implementation, in many countries the introduction of an MTEF into the budget process itself did not result in much better budgeting outcomes.

The seminar was designed to take up this issue. It investigated what lies beyond the introduction of an MTEF framework mechanism. What building blocks are

required for such a mechanism to ensure that decisions on the raising of public resources and how they are allocated are taken in view of the medium-term impact of these decisions? It also asked what the common obstacles are to an effective medium-term perspective and how they can be overcome. Within this overall theme the seminar selected specific sub-issues to examine in depth: understanding the impact of legacy systems on medium-term budget reforms; raising domestic revenue for fiscal stability; using a medium-term perspective to address fiscal crises; designing better budgeting rules; planning for capital spending; and including external development assistance effectively in the budget process.

This paper uses the papers presented in this book and the discussions at the seminar to explore what the barriers in CABRI countries are to implementing a medium-term (or multi-year) approach to budgeting and how they can be overcome. It proceeds from the understanding that a medium-term perspective is critical for linking policy, planning and resources because it ensures that policies are affordable and effective, while contributing to a stable funding environment for policy implementation.

The paper is divided into three parts. In part one it discusses the relationships between affordability, risk and medium-term stability and country experiences in managing these aspects. In the second part it looks more closely at country experiences with regards to policy and spending effectiveness in a medium-term approach. In part three it turns to two factors that have hindered the implementation of medium-term budgeting overall: embedded budget practices and the fragmentation of budgets on account of external development assistance. This discussion does not, however, attempt to provide a comprehensive account of the papers in the volume: it merely highlights and directs the reader to interesting aspects. The papers themselves offer far richer discussions on the specific topics.

1.1.2 Affordability, risk and medium-term stability

In reality, budgets are not zero based. They carry forward the implications of spending decisions that were taken in the past. If decision-makers are to determine whether a policy – albeit a new public service that will be offered or a change in the level of a service that is already offered – is affordable before introducing it, they need to not only look at current revenue flows and policy cost, but at likely future revenue flows and cost, given likely changes in the environment. It is also not enough to consider the cost of the single policy against future revenue availability; decision-makers need to know what the marginal additional cost will be. In other words, in order to make sensible decisions about new spending in the present, budgetary decision-makers require robust analysis of the future cost of continuing with government services given current policies.

Another way of looking at the affordability test is from a risk perspective. The requirements of medium-term thinking enable governments to analyse risk better. Framing policies, revenue and spending in a medium-term macroeconomic forecast – taking into account the impact of policies – gives governments the tools to assess financial risk. Non-financial risks can equally be assessed and factored in. For example, if a government intends adjusting education policy so that no pupil has to travel further than three kilometres to a school, what would the impact of a reduced pupil teacher ratio be on teacher demand and supply if the decision is to build additional schools? A medium-term planning and budgeting horizon creates an environment within which the education department is more likely to think ahead and factor in the medium-term labour market and construction industry risks, and adjust their policy or design complementary policies.

The quality of forward estimates

The need to ensure the financial affordability and operational feasibility of policy proposals has been a major factor behind the introduction of medium-term perspectives. However, in order to do that well governments need to be able to generate robust forecasts of forward macroeconomic conditions and revenue flows, as well as of the forward cost of existing and new policies. While the former is usually the responsibility of the centre of government (through the introduction of good macroeconomic models and mechanisms to consult on forecasts with stakeholders such as the central bank, the revenue authority and independent research agencies) the latter can only be done well using the specialised knowledge at sector or spending agency level.

Spending agencies therefore need to provide the centre of government with a realistic assessment of their financial requirements over the medium term. In principle their financial requirements would consist first of the forward cost of policies that were approved in the past, resulting in services that they are already delivering and goods that they are already supplying and which they either want to continue or are obliged to through legislation. The second component of their forward financial needs comprises new spending that arises out of new policy proposals or new legislative requirements.

A proper assessment of the financial affordability of policies needs to be supplemented by an assessment of operational feasibility. In order to deliver optimally against their mandates and policy objectives, spending agencies therefore need to look beyond just one year in preparing implementation plans for policies. This is made possible by the availability of information on likely forward funding, given fiscal circumstances, and in turn provides for proper costing of policy implementation. Good quality forward estimates would therefore reflect good forward planning.

It is, however, a common complaint across CABRI countries that the quality of forward spending estimates is generally poor. They consist far too frequently of the proposed budget for the first year of a multi-year framework, followed by inflation adjusted projections of cost for the outer years: multi-year incrementalism in other words. They pay little attention to, for example, the likely phasing of policy implementation, changes in demand that will affect spending unevenly or the impact of once-off capital spending on the base-year estimates. In total, the forward estimates rarely provide a strong basis for assessing the marginal affordability of any one policy. A key aspect of embedding a medium-term perspective therefore is deciding what the rules are for rolling over and adjusting or determining the forward estimates.

Chapter 4 looks at the practices of Namibia and Ghana in this regard. While both countries are implementing medium-term budgeting and expenditure frameworks² they use baselines, ceilings and floors differently in the budget process. In Namibia, spending agencies use the forward estimates of the previous year effectively as a ceiling to prepare a new budget bid. While marginal changes to this ceiling are allowed (see next section on spending effectiveness for further discussion), spending agencies have learned over years that such adjustments are tough to secure. Increasingly therefore, the focus is shifting from ensuring proper planning for the budget year, to getting in the right assessment of need for the new outer (or third) year, the only year that is in principle open for the introduction of new spending. In Ghana, by contrast, new money that is available in the budget framework is allocated up front, in line with a top-down assessment of priorities before individual ministries' bids are heard. While the early process is very much concerned with ensuring affordable, effective spending – and while there is sound logic in allocating new money up front in line with priorities rather than by a consideration of spending proposals – it does mean that many ministries undervalue planning for the medium term and wait for their new ceiling to be issued before starting budgeting. The well regarded medium-term budgeting principle that the budget system needs to make sure that the forward estimates are a telling foundation for new allocations, is borne out by the contrast between these two examples.

During discussions on the Ghana and Namibia papers at the seminar a long-standing question was raised: what guarantees should spending agencies have of their allocations in the outer years? Given that budgets need to cope with risk, how can funding be guaranteed? And if funding is guaranteed, would that not weaken incentives for ministries to perform and/or to look for savings in their own baselines to fund new priorities? The use of contingency allowances in the framework as a cushion against uncertainty has become increasingly common practice in countries. The discussion also indicated that while funding should therefore be more or less

guaranteed, it should still be conditional on performance by the line ministry. Failure to use funds or to use them well should result in lower new allocations at the least or in the reduction of past allocations, if required.

Other important similarities are evident in the two case studies and emerged in the session. The first is the financial discipline of a medium-term fiscal framework as a constraint on spending. The second is the importance of stronger process discipline by ministries of finance. Even if serious attention to medium-term costing of policies seems more difficult in the Ghana context, this can be engineered by making access to additional funds more difficult for ministries that have less well-developed and costed plans. A budget process can, however, only be disciplined if it is transparent, predictable and accountable. The importance of the use of public documentation, a clear calendar, standard structures and processes, clear decision-making criteria and the engagement of cabinet as the final decision-maker also emerges clearly from the papers.

Importance of medium-term stability

The ability to calculate the full cost of policies and ensure that they are affordable and feasible in the medium term, is important for managing risk and ensuring that policies are sustainable. By implication it also results in higher macroeconomic, fiscal and policy stability. This in turn has benefits for a country's credit rating or its ability to access external development assistance, and helps build investor confidence and trust in government. When these types of factors take a turn for the better, they ease a country's fiscal circumstances and its ability to deliver on its development objectives. Within a medium-term approach to budgeting fiscal stability is also made more possible in that government has a medium-term horizon over which to absorb macroeconomic shocks or plan for the gradual improvement of fiscal outcomes.

On the other hand, experience with the implementation of medium-term frameworks has also shown that they require macroeconomic stability to be implemented. Many CABRI members have faced the dilemma of wanting to implement a medium-term approach in order to create a more stable and strategic spending environment, and failing because of macroeconomic instability.

In Chapter 3 of this volume, Rwanda and Malawi review how they used a medium-term perspective to turn around the fiscal balance and other macroeconomic fundamentals by phasing policy interventions. Important lessons emerge from both case studies, particularly around the connection between stability and medium-term budgeting. In the case of Malawi, while its policy interventions show how to use a medium-term fiscal framework to plan one's way out of a fiscal crisis, the 2002 fiscal crisis itself was the result of crisis short-term policy adjustments and inadequate

assessment of medium-term risk. Short-term thinking around budget balances, tax policy and parastatal management and poor assessment of medium-term food security and external financing risk, combined with fatal flaws in budget and financial management practices, led to more pressure on the budget, poorer revenue flows and an over-reliance on domestic debt.

In Rwanda the realisation that a minimum level of policy and macroeconomic stability is required before a medium-term expenditure framework can be introduced effectively was very valuable. The post-genocide period was therefore mostly concerned with stabilising the public finances including through external and international financial institution assistance, getting basic budgeting and civil service systems up and running, and kick-starting the flow of domestic revenues. It is only after this period of recovery and reconstruction that the government could look at using explicit medium-term mechanisms to undertake macroeconomic management.

Mobilising domestic revenues

The importance of a steady stream of domestic revenues is underscored by both the Malawi and Rwanda case studies. It also plays an important role, although less highlighted in the papers themselves, in the Ghana and Namibia systems. The two remaining papers in Chapter 3 therefore look at the use of tax policy and tax administration reform to stabilise and boost domestic revenue. The overview paper of tax reform interventions describes the elements that make up successful programmes. They include organisational redesign, including establishing revenue authorities and shifting from a tax and geographical focus to a combination of functional and taxpayer segment design elements. Other aspects include implementing systems and procedures that are based on the principle of self-assessment and supported by risk-based controls. These reforms are typically implemented in the large taxpayers offices as first steps towards a complete transformation in tax administration. Many benefits are expected to accrue with the reforms, including: improved tax compliance; more equitable distribution of the tax burden; consistency and fairness for taxpayers; reduced compliance costs and better services; reduced tax evasion; and greater transparency and integrity.

The Uganda case study describes how these types of reforms have been implemented in the country, combined with adjustments to tax policy which sought to simplify the tax code, move to economically more efficient tax forms and broaden the tax base. The combined effect of the reforms have been limited: while the tax to GDP ratio did increase, it is still below that of many other countries in the region. This illustrates the difficulty of engineering compliance

when the embedded practice is non-compliance (an echo of the problem of overcoming legacy budgeting systems discussed in Chapter 2). The case study also leaves open the question of whether the incentives to fully transform tax systems are sufficiently strong in countries with significant and relatively stable external development assistance support.

In summary: policy affordability, sustainability and stability are significant benefits of a medium-term perspective. They will, however, only ensue if good forecasting systems are in place for all budget parameters and cost, and if they are required by the demands of a disciplined, transparent and accountable budget process. A medium-term perspective however, is only possible when revenue flows are stable. This is partly a function of conservative budgeting and the use of contingency reserves (when revenue estimates are conservative and a contingency allowance is included in the budget framework on the expenditure side, a cushion against uncertainty is built in), but also requires efforts to stabilise the macro-economy and strengthen tax collection.

1.1.3 Policy and spending effectiveness

A second potential benefit of a medium-term perspective is allocative efficiency, or the effective use of available resources to address priorities. Policies are effective when they are funded and implemented in such a way that they address their objectives. A first condition of policy effectiveness therefore is a sound assessment of affordability. There is little use in designing and approving policies which will not be funded over the medium term because they were not affordable given a country's fiscal capacity, access to external finance and other spending obligations.

Policies are also likely to be implemented more effectively and efficiently when there is certainty of funding. In-year crisis adjustment to spending plans because of cash shortfalls leads to interrupted and/or incomplete service delivery and higher cost per unit of service delivery. Medium-term funding certainty on the other hand means that spending agencies can plan better for the phasing of policies and can implement them as a continuous process over many years, rather than on a start-stop basis as budgets are approved.

Individually effective policies and policy implementation, however, does not mean that spending overall is necessarily effective. For this to be the case, the best possible trade-offs between competing policies have to be made in line with government's priorities within affordable revenue flows. This too is done better when budgeting occurs with a medium-term horizon. It provides governments with the space to make trade-offs between policies within the context of their cost over many years.

Another way of looking at this benefit is by contrasting medium-term budgeting

with the incrementalism that has become associated with an annual approach to budgeting. In a working medium-term system, incrementalism will be tempered by finance ministries and spending agencies elbowing open fiscal space within available funds to fund emerging priorities.

A simple truth in budgeting is that it is inevitably incremental, for two reasons. First, zero-based budgets are not possible because past policies create future obligations. Second, they are also not possible because there is neither the time nor the capacity in any budget system to look at every policy and every unit of spending. A large part of budgeting will therefore entail taking the allocations of the previous year as a base to calculate the new budget. Budget shifts will therefore always only happen at the margin. The challenge is to make sure that the margin is as large as it can possibly be.

Budgeting rules and spending rigidities

Spending rigidities, in other words the limits placed on moving funds around arising from existing entitlements and contracts, and budget structure reduce the ability of governments to reprioritise funding or to increase the size of the margin of change in any one year. A medium-term perspective offers much more scope for dealing with the former. First, countries can mark when contracts end and use the resources that become available for higher priority spending. Second, there are very few spending entitlements that are rigid in the medium term. High personnel cost, for example, can be managed downwards by using attrition and inflation to reduce its share of the budget over as many years as are required (and as slowly as is required taking into account labour market factors). A key aspect of effective reprioritisation over the medium term is for spending agencies to interrogate their existing spending better before asking for new money. In both the Ghana and the Namibia case studies the use of budgeting rules, the information requested during the budget process from line ministries and a robust central challenge function to ensure that ministries look towards themselves first, are well illustrated.

Budget structure, however, often limits the adjustments that can take place. While it may be clear to spending agencies that some policies and public services are lower priority or have become obsolete, calculating how to reduce spending on such services by reducing inputs is difficult. Implementing the changes is even more complex when budget structures do not make clear how inputs are to be used among objectives.

A programme focus

Demonstrating the usefulness of a medium-term perspective therefore requires clear identification in the budget documentation of spending with programmes. If this

is absent or not effective, budget allocations revert to being driven by inputs and the incremental increases of inputs. The Kenya and Burkina Faso case studies in Chapter 2 pick up well on this point. It is further emphasised in the overview paper of francophone and anglophone systems – also in Chapter 2 – that a single focus on specificity (or detailed allocations to inputs for input budget controls) in the budget structure that goes to parliaments is not useful for spending effectiveness. Budget reprioritisation is a prerequisite of spending effectiveness (otherwise the proportion of the budget that is truly aligned with emerging priorities will shrink as the budget grows). Reprioritisation requires strategic decision-making. This is only possible if the budget structure allows a fairly high level view where allocation details do not obscure key trade-offs.

Ghana and Namibia case studies offer further insights in this regard. While a clear programme structure is a necessary starting point for strategic decision-making, it should be accompanied by a medium-term emphasis on results. In Namibia, spending ministries can only access additional funding over their previously allocated ceilings, if they can demonstrate that such adjustments are required to maintain or improve their policy outcomes. The case studies and discussion presented in Chapter 2 provide further examples. In Kenya there is a concern that stronger involvement by parliament will not lead to more effective, medium-term budgeting in the current system where the standing orders of parliament require the budget merely to be structured by inputs without much contextual information. In Burkina Faso, efforts to improve allocative efficiency are undercut too by the legal requirements for a budget that is structured by inputs and which is seen as a tool for financial control, rather than strategic policy-making.

Capital budgeting

Good service delivery is a function of spending on recurrent inputs and the state of a country's capital stock, not capital spending. This insight into the challenges of capital budgeting for spending effectiveness is used in the South African capital budgeting case study in Chapter 4 to explore the need for and impact of capital budgeting in an effective medium-term perspective.

It is precisely because the value of spending on capital items is realised only over time, in contrast with spending on recurrent items, that it is planned separately in many countries. Over the medium term the impact of capital spending is simply to maintain and improve the capital stock: the effects of capital allocations (or lack of them) are therefore only felt over a long time, because it is not the spending that directly affects outcomes. A medium-term perspective provides countries with the tools to assess the risk of insufficient spending better. It is not merely a risk at the

sector level, but also a risk centrally. Low capital spending by government and a deteriorating stock of capital has macroeconomic as well as service delivery impacts.

However, if capital and recurrent spending are not joined up in medium-term planning, the risk is under-providing for the recurrent cost of capital spending. On the other hand having a single system runs the risk of under-spending on capital stock, poor project appraisal and not keeping proper track of capital projects.

The South African case study provides a good overview of the challenges of capital budgeting and key choices that countries face, among others whether capital spending should be planned and overseen centrally. It discusses the South African system in which line ministries budget for capital spending in a single budget system and present it not by project, but merged into the budget in a single budget structure. The pros and cons and mitigating mechanisms of the system are discussed, including the existence of a capital budgeting committee at the centre that reviews mega-projects.

The Botswana case study is presented as part of the South African paper. In contrast, Botswana has a dual budgeting system, which in turn manages the risk of a disconnect between recurrent and capital by having capital spending disciplined by a medium-term plan, undertaken by line ministries and overseen by a joint capital and recurrent committee.

In summary: a medium-term perspective is essential for ensuring spending effectiveness. At the very least it is necessary to make sure that individual policies are well planned, take into account all risks and are affordable. It is also necessary for the centre of government to make sound trade-offs between competing policies. A medium-term perspective, however, is not sufficient: it also requires budgets to be structured by the objectives of spending (or by programmes), aggregate budget categories that support strategic decision-making and for a results orientation to be operational in the budget process.

1.1.4 Barriers to medium-term perspectives

The first and concluding chapters of this volume address two significant barriers to implementing a medium-term perspective, even when countries undertake many of the interventions detailed above.

Legacy systems in francophone and anglophone countries

Chapter 1 reflects the discussions at the seminar on the differences between francophone and anglophone systems in Africa and how they may affect the implementation of standard reforms such as a medium-term perspective.

The Burkina Faso case study, together with the francophone/anglophone overview paper, provides an overview of the rigidities found in francophone systems based on

inherited French budgeting rules and allocations of responsibilities. It highlights that while francophone systems have budget control benefits and offer some mechanisms that are not out of keeping with a medium-term perspective (such as allowing for capital programming to have a multi-year legal basis in the financial laws), they also present important challenges. These challenges are then discussed in more detail in the context of the reforms in Burkina Faso. The central control over spending ministries discourages spending agencies taking strategic responsibility for better spending and the budget format does not assist either. With a strong emphasis on law, the lack of legal provisions for modern budget management mechanisms such as MTEFs and programme budgeting mean that reforms to these effects have very little impact. The requirement to adhere to the West African Economic and Monetary Union (WAEMU) directives, however, has driven successful reforms of key parts of the public financial management systems.

The Kenya case study, on the other hand, furnishes rich material for reflection on the clash between a Westminster financial management inheritance and the constitutional form of the modern Kenyan state. The role of parliament in undermining comprehensive, medium-term budgeting that is affordable and effective is discussed. The study also looks – in contrast to the Burkina Faso study – at the impact of decentralised budget management on budget control and financial statements.

In both studies, however, the link between budget law reform and the effective implementation of a medium-term perspective is clear. The overview paper takes this theme forward and looks at how effective African countries have been in implementing the standard reforms. It emphasises that the WAEMU directives limit the implementation of medium-term perspectives legally. In anglophone countries the strong legal emphasis on the accountability of spending agency accounting officers in turn undermines a strong finance ministry mandated to run a disciplined budget process. The weak role of parliaments and inadequate capacity for medium-term forecasting, particularly at sector level, further affects the impact of these reforms.

Bringing donor support into the budget process

The management of external development assistance, particularly in countries that are more aid-dependent, is critical in creating the conditions in which countries can truly make sound budgeting decisions for the medium term. When budget decisions are made without taking aid fully into account, they are based on incomplete information and would not have assessed revenues, spending and risk fully to check for affordability and effectiveness. Also, where aid is unpredictable, variances in revenue flows undermine the stability in which medium-term perspectives flourish.

The CABRI aid on budget study, conducted in collaboration with the Strategic

Partnership for Africa, took as its departure point that bringing aid on budget is not an end in itself. It needs to be done in such a way that it supports the effective use of the funds and builds better country systems. The study therefore looked at all the stages of the budget process to define what aid on budget would mean in each and why it is important that aid is integrated. It researched the interface between aid and budget management in ten CABRI case study countries against the framework to identify issues and good practices. The final chapter of this volume provides a summary of the main findings of the study. It highlights principles for bringing aid on budget based on the emerging good practices in countries. A key finding is that it makes little sense for overall spending effectiveness to conceive of aid management reform and public financial management reform as two separate processes: they should be integrated far more closely.

1.1.5 Conclusion

The short and medium-term imperatives of public finance management often clash. At times the need for short-term macroeconomic stabilisation may compete with the demand for medium and long-term spending on public services. The reverse can also occur when short-term demand for spending has unpalatable medium-term macro-economic implications. Having a budgeting system that balances short and medium-term requirements is therefore crucial. The waves of budget reform focused on implementing and strengthening medium-term budgeting that have swept across the world over the last two decades are testimony to the recognition of this budgeting value.

CABRI countries are no strangers to these efforts. Early versions were the forward planning budget implemented in Kenya in the 1980s. The preparation of public investment programmes similarly tried to address the need for a medium-term view. The first medium-term expenditure frameworks were introduced in the 1990s, first in Uganda and then in South Africa and Malawi. Many other countries followed suit. However, as highlighted in the francophone/anglophone overview paper, many of these initiatives have not been completely successful.

The 2007 CABRI Annual Seminar looked behind the standard medium-term reform frameworks to explore specific building blocks, such as budgeting rules, improving fiscal stability and budgeting for capital spending. This volume reflects on the discussions at the seminar and contains the following insights, as highlighted above:

- Budget discipline is important. There are two types of discipline, both of which play a critical role. First, fiscal discipline: finance ministries will not be able to encourage budget decision-makers to think medium term unless

they can demonstrate medium-term budget constraints. Second, process discipline: legacy systems and practices are deeply embedded and rooted in annual, input-focused incremental budgeting. A firm, determined hand – with political support – is required at the centre to change the rules of the game.

- Relatedly, the budget system must make the forward ceilings count. A medium-term perspective is dependent on forcing decision-makers to plan beyond the first year. Unless they are forced to live with poorly prepared estimates when they finally roll over into the budget year, a shift to medium-term thinking is unlikely to occur.
- Finance ministries should be aware that stability is both a product and a pre-condition of a medium-term perspective. In highly volatile environments decision-makers do not see much benefit from efforts to plan ahead. Reaching a minimum level of stability requires first looking at macro issues before drilling down to micro allocations.
- On the other hand, short-term decisions that do not assess medium-term risk well, can trigger chains of events that end in fiscal crises and macroeconomic instability.
- Thinking medium term is about thinking more strategically. The budget system should be geared to focus on strategic trade-offs at the margin of the budget. The higher up the decision-chain, the more strategic the decisions should be.
- Some focus on the results of spending is essential. Inputs are important and even when budgeting is by output, inputs still need to be costed. However, without a discussion about the expected results of spending, talking about inputs turns far too easily to the past to come to a budget for the future.
- A medium-term perspective by definition requires comprehensive planning. It is not possible to assess medium-term risks and impacts without having a view of all of spending relevant to the decision. This means that aid should be integrated with the budget process and that the barriers between capital and recurrent spending should be broken down. However, the latter should be done without throwing the baby out with the bathwater: there is a reason why dual budgeting systems moved to planning capital spending separately.
- Reformers should be aware of the legal frameworks that are in place, their impact on the behaviour of budget decision-makers and sequence their reforms accordingly. Be careful when introducing medium-term perspectives in a context where law is narrowly applied if the law requires annual budget

formats and decisions. Similarly, don't expect a change in law to ensure successful reforms in contexts where practice determines what legal reforms can be successful.

- Finally, a medium-term perspective is dependent on good information. Reformers should build a medium-term perspective by ensuring that the potential capacity to produce forecasts is in line with the demands that will be placed on it in a new system. In short, keep it simple at first to demonstrate success.

Endnotes

1. A distinction is often made between using multi-year projections and multi-year budgeting. In the first case budget decisions are still taken on an annual basis, but in the context of forward macroeconomic projections and estimates of revenue and expenditure, usually published to ensure their quality. In the second case budget decisions are taken for periods that are longer than one year. In this paper and volume generally, the term multi-year budgeting is used more inclusively, to refer to any form of budgeting that uses a multi-year perspective, unless it is clear from the context that the more narrow use applies.
2. Increasingly budgeting literature is distinguishing between medium-term budgets (or fiscal) frameworks and medium-term expenditure frameworks. While the former refers to the top-down framework that determines what is affordable given the macroeconomic outlook and estimated revenue flows, the latter provides a more or less detailed projection of how the revenues will be allocated to expenditure categories over the medium term.

2

**Legacy systems and legal framework
practice in the francophone and
anglophone traditions**

2.1 Introduction

Different legacy systems affect the introduction of medium-term expenditure frameworks differently. This chapter examines anglophone and francophone systems in Africa to identify how different budgeting legacies may require adaptations to standard reform programmes.

In the first paper, Halidou Ouedraogo, Economist in the Ministry of Economy and Finance in Burkina Faso, examines how the French public finance management ordinance of 1959, together with West African Economic and Monetary Union directives have shaped budgeting in francophone countries. While he identifies positive consequences of the system for medium-term budgeting, he also discusses several negative factors. In examining the Burkina Faso reforms against this background, he notes that the emphasis has been on legal reform and the implementation of new laws. Other reforms that have not affected the legal basis for budgeting, such as the introduction of a programme budget, have been less successful.

Kubai Khasiani, Deputy Director, Budget in Kenya, discusses the tension between the country's legacy anglophone system of budget management, and its constitutional form which contains significant elements of a presidential system. In Westminster parliamentary systems – the source system for anglophone African countries' financial

management practices – parliaments are usually relatively weak and constrained to oversight after the fact. In presidential systems, however, legislatures wrestle for more say on spending before the fact. He discusses the rising contradictions in the current Kenyan system and the demand they place on key principles for medium-term budgeting, such as budget comprehensiveness, transparency and a disciplined budget process. He also identifies embedded practices regarding the allocation of responsibilities between the central finance ministry and line ministries that affect, among others, arrangements for internal audit and the preparation of reliable financial accounts. Overall, legacy systems therefore influence which issues should be addressed first in the country's reform programme.

In the final paper, Ian Lienert, Senior Economist in the IMF Fiscal Affairs Department, examines how ten good practice budget management principles are applied in anglophone and francophone systems in order to identify key differences between the systems. Against a backdrop of the diversity of ways in which European countries have implemented medium-term perspectives, the experience in African countries is then examined. The paper highlights that a key issue is differing attitudes to the role of law in promoting budget reform. However, the paper emphasises that while it is necessary to pay attention to legacy system issues, there are other constraints that thwart the introduction of effective medium-term systems more.

2.2 Burkina Faso: Multi-year budgeting and francophone systems

Halidou Ouedraogo

The purpose of this paper is to investigate how budgetary reforms towards multi-year budgeting have been effected in francophone countries. The paper begins with a description and evaluation of multi-year budgeting in francophone systems, looking at the legal framework, and assessing both the positive and negative features of the system for multi-year budgeting. It then examines how this impacts on the budget system in Burkina Faso in particular. A discussion follows on what further reforms are necessary for effecting multi-year budgeting in francophone systems. The paper ends with a short conclusion.

2.2.1 Multi-year budgeting in francophone countries

Introduction

During the last decade and a half, many CABRI members have made significant efforts to reform their budgetary structures, processes and institutions in order to introduce a medium-term management perspective. In spite of the evolution of

systems in these countries, it is apparent that budgeting is still done on an annual basis. Medium-term budgetary practices are seldom implemented and collection of revenues remains poor.

In the majority of CABRI member countries, a significant proportion of the budgetary reforms has consisted of improvement of systems with a view to implementing a medium-term perspective.

The legal framework of budgetary control in francophone countries

Francophone African countries inherited their budgetary system from their colonising country, France. Ordinance number 59 of 2 January 1959 is the organic law for France's public financial system, and which for the decades up to 2001 constitutes the basis for public financial legislation and the legal framework structure. This ordinance defined the jurisdiction and powers of government and parliament over the finances of the state. Moreover, it laid down the major principles of budget law, which are imperative for all public budgets.

Since 1959, the political, institutional, financial and European context has evolved significantly, as well as the perception of the role of parliament in budgetary and financial matters. The ordinance was finally thoroughly reformed in France and a new legal framework adopted in 2001; this came after 40 years of uninterrupted criticism and reform proposals. The new organic budget law (OBL) was implemented with the 2006 annual budget.

In the francophone countries of Africa, the 1959 ordinance has remained the main influence on the legal framework for budgeting. But circumstances in these countries have changed. For example, the economic and financial reforms supported by the Bretton Woods institutions on an international scale have consequences for the budgetary legal framework existing in the countries. The objectives are to improve the effectiveness and efficiency of public expenditure. The reforms include results-based management, which requires multi-year or medium-term budgeting.

In francophone countries the reforms to institute medium-term budgeting were introduced in the context of legal frameworks which were based on the French system and which presented both opportunities and obstacles. These will be discussed in turn below.

Positive features of the francophone system for medium-term budgeting

The current francophone legal framework offers opportunities for medium-term budgeting through exemptions permitted from the strict principle of annuality in budgeting. The annuality principle stipulates that budget authorisations should be given once a year by the legislature for a period of one year.

Multi-year authorisation of capital projects

In the francophone system, government can require of parliament – within the framework of the budget – an overall programme authorisation for each capital expenditure programme with an investment plan that is spread out over several years. The multi-year programme authorisation fixes the maximum ceiling of expenditures necessary for the execution of the programme. This is translated into annual payment appropriations that need to correspond to the upper limit of expenses that can be authorised and paid during the year within the framework of the corresponding programme authorisations. Also, programme authorisations related to government capital expenditure in a given sector can be grouped together in a law that is set out by programme, rather than by administrative or budget-holding entities. Moreover, credit carry-overs are authorised for the unspent balances of annual payment authorisations corresponding to a multi-year programme and programme authorisation (see below). Even if they are not always used, these provisions, which have been in place for several decades are the fore-runners of today's multi-year budgeting system. In the francophone system, however, they only apply to capital spending. Different rules apply to recurrent expenditure.

Credit carry-overs

Credit carry-overs authorise the re-appropriation in the following budget of appropriations that were not used up during the past year. They are common for investment activities (see above), and may be used only exceptionally for operational activities. In Burkina Faso for example, the financial laws authorise carry-over possibilities without exact limits in the financial laws themselves, although they may be specified through subsidiary legal texts. (The financial laws are the francophone equivalent of the anglophone appropriation acts.)

Voted services

The francophone system makes a distinction between the forward cost of policies already authorised in previous budgets, and new spending. The voted services mechanism allows the renewal of former appropriations, thus ensuring the continuity of approved services. These voted services are taken into account during the development of the medium-term expenditure framework (MTEF) under the name of 'benchmark envelopes'.

Separation of powers

Although parliament, in line with the francophone tradition of codifying rules, has significant once-off input into the budget system in the annual budget process,

government actually has more power than parliament in budgetary matters. While this is a weakness, in the sense that parliament is not vested with strong powers of scrutiny and oversight, (see paragraphs below), it is a strength in the sense that financial authority is vested in the executive and in the finance ministry.

Negative features of francophone budgetary systems on medium-term budgeting

Among the obstacles to multi-year budgeting, is the entrenchment of the principle of annuality, and the principle of the single payment authorising officer overseeing many ministries, departments and agencies.

Principle of annuality

This is a general principle of duration, which specifies the one-year period of the budgetary authorisation granted by parliament. Government is obliged to present itself before parliament each year in order to obtain budgetary authorisation. At face value, this entrenched principle – a central tenet of the 1959 ordinance – undermines the introduction of medium-term multi-year budgets into the budget preparation and approval processes. This is not necessarily the case in the new French system, however, where annual budget approval occurs within a multi-year programme. However, the years of strict adherence to annuality in francophone systems have created a system of budgeting which has proven very difficult to break, or change, even when opportunities to do this have presented themselves.

Principle of the single payment authorising officer

In francophone countries, the notion of a single payment authorising officer gives the finance minister all the rights and prerogative to authorise all payments under the state budget. In Burkina Faso, for example, the finance minister is the single authoriser of payments in the state budget, which clearly gives the Ministry of Economy and Finance (MEF) a tight hold on the budget. This power to authorise receipts and expenses is delegated to the budget director. This practice may and often does create bottlenecks in the system. It is also a disincentive for sector institutions to take full responsibility for medium-term strategic thinking and management of resources in their sectors.

Rigidity of the legal system

In francophone countries operations dealing with external financing follow different procedures from national procedures. The stipulation of roles and responsibilities and due process in the system requires different procedures for funding that comes

from external sources. This means that there are multiple channels for public expenditure execution channels, which hampers budget co-ordination, integration and sustainability. It also makes the funding of public services more opaque.

For example, procedures for external funding do not follow the rule of the single authorising accounting officer. The rule of treasury unity, whereby all revenue and payments are made from a single account, is thus infringed. Although, theoretically, externally financed operating expenses and capital expenditure fall under the control of a third party in charge of their management, in practice, the operations are initiated by state project managers. The project managers approve the expenditure and even have the authority to sign cheques against bank accounts in which the funds were placed. These procedures are thus completely different from those applicable to domestically financed expenditures.

In practice the rigid legal system – aimed at codifying and therefore controlling the behaviour of budgetary actors – often does realise these benefits. However, although the systems instituted by the legal framework for budgeting are very close, even identical, to what appears in the 1959 ordinance, the framework is often either dead letter in all or in part, on account of distortion through practice, poor training, poor information availability or misapplication of procedures.

Limited rights of parliament

While the idea of ‘rationalised parliamentarism’ inspired France’s Constitution of 1958, in some ways the 1959 ordinance has gone beyond the constitutional regulations regarding the role of parliament. For example, Article 4 of the ordinance simply excludes parafiscal taxes, such as levies, from the application of Article 34 of the Constitution, which states that all statutes of government shall be passed by parliament, including those which set ‘the basis, the rate and the methods of recovery of taxations of all kinds’. While a powerful role for the executive can contribute to better budget management, the legal framework for parliament’s involvement does need to provide it with a strong enough oversight mandate lest accountability suffers.

Lack of clarity in the financial transactions of the state

In addition, the ordinance allowed the development of practices which hardly promote fiscal transparency. The accounting system results in different sets of accounts at different points in the budget execution cycle. The cash basis of the accounts leads to confusion between budgetary operations and cash transactions, and in turn, there are variances between different sets of accounts that are very difficult to reconcile. This allows the fiscal deficit to be manipulated. In short, the ordinance

does not demand sufficient transparency in public finances and creates opportunities for the manipulation of information, thereby not facilitating parliamentary control or effective budgetary control.

A management framework that is too rigid and does not confer enough responsibility

The principle of specificity, – the allocation of money to specific purposes without much flexibility – reflects one of the objectives of the ordinance, which was to provide government with firm managerial instruments for budget management. However, the application of the principle actually hinders the development of a performance approach in the management of public services, since it focuses on the allocation of funds to specific input line items rather than to activities, strategies and objectives.

Inaccuracies and gaps

France's 1959 ordinance shows a number of inaccuracies and ambiguities, which the constitutional council has had to highlight in many of its decisions: for example, the failure to provide for the budget being utilised not only as an accounting instrument, but as a strategic economic and financial tool that supports and executes the nation's economic and social policies.

A significant gap in France's new OBL is that it does not take into account sufficiently the important role that the state plays in the financing and control of social security, which is determined outside of the budget through separate legislation. However, currently, and in particular in the West African Economic and Monetary Union (WAEMU) community, the prevailing wisdom is a global concept of the cost of the state. This means an all-inclusive notion of financial transactions, not only under the state budget, but also of social security and territorial authorities.

As a country steeped in the French tradition of public financial management, underpinned by the 1959 ordinance, over the past few decades, Burkina Faso has struggled with these obstacles to reform, because of the legacy of its budget systems. In the next section we look at how the country has implemented reforms within the context of these traditions and its membership of the WAEMU community.

2.2.2 The budgetary system of Burkina Faso

Introduction

In Burkina Faso, as in other West African states colonised by France, the advent of budget law dates from the colonial period. A decree of 30 December 1912 initially governed public finances in the overseas territories. The budgetary procedures arise

from the various constitutions which Burkina Faso has had since 1960 (in particular, Article 103 of the Constitution of 2 June 1991).

The formation of the WAEMU in 1975 means that regional legislation also affects internal budgetary structures. Member states are obliged to implement acts of the union notwithstanding any previous or subsequent contradictory national legislation, so all national public finance legislation has to adapt to the union directives. The objective is that the implementation of these directives facilitates modern and effective instruments that ensure rigorous and transparent management of public finances, guaranteeing stability of the common currency, as well as reliable and comparable financial and budgetary data to make it easier to carry out multilateral monitoring.

Characteristics of budgetary system reform in Burkina Faso

As with most francophone countries, the Burkina Faso budgetary system remains based on the 1959 ordinance. The main WAEMU directive that currently shapes the system is directive number five of 16 December 1997, which specifies the characteristics and methods of budget control in all member states. Before the reforms in terms of the 1997 directive, the primary domestic benchmarks of budgetary legislation were the Constitution of 2 June 1991 and the ordinance of 18 September 1969.

Reforming the legal framework

The initiation of reforms in the Burkina Faso systems involved applying WAEMU community directives relating to the legal, accounting and statistical framework of public finances. Coupled with the entrenched francophone tradition of the legal codification of systems, this meant that legal reform had to be a focus.

In 2003, parliament approved two laws, which underpinned the framework for the budget law and the general structure and classification of the state budget. Together with the 1991 Constitution and the 1969 ordinance, these laws now form the cornerstone of the system. By 2004 the new budget structure was successfully introduced, including the necessary adaptation of the financial information management system.

In 2004, the new state accounting standards (SAS) were adopted by decree. These were implemented in the financial information management system accounting package. A set of procedures has also been developed as well as guidance on the technical framework for the state accounting system. A committee was set up in 2004 to monitor the application of the standards.

In 2005, other regulations were adopted through decrees relating to the system of payment authorising officers, the system of financial appropriation administrators in departments and other state agencies, and the system of public accountants and the regulation of the public accounts. Methods of assessment of state financial transactions

were also regulated. The adoption of these texts sanctioned changes to the existing financial system, which had framed the financial transactions of the state for more than 30 years. A particular challenge during the drafting of the new regulations was to ensure that all former provisions that were still required were covered, to avoid gaps that could weaken the legal framework for public finances. To ensure coherence, a correlation table was drawn up to facilitate the application of the new regulations. The texts are to be grouped in a comprehensive booklet which will be distributed to all participants in the budget process.

Other reform steps

However, reform efforts in Burkina Faso were not only driven by legal requirements. An early WAEMU baseline assessment of member country public financial management systems was useful in pinpointing key weaknesses in practice. Within the framework of WAEMU, regardless of their level of development, all states are required to draw up and adhere to clear principles that uphold financial orthodoxy and sound and transparent management of public finances.

The baseline study identified the following common weaknesses:

- weak public finance legal frameworks that are poorly implemented
- non-documentation of financial and tax codes and inadequate application of documentation that already exists
- absence of procedure manuals
- weak implementation, delays and significant backlogs in rendering state accounts and submitting final audited accounts for parliamentary approval
- lack of awareness of existing texts on the harmonisation of legal, accounting and statistical frameworks in the WAEMU
- non-utilisation of inspection and verification reports
- weakness of jurisdictional and parliamentary audits
- inefficient management of human resources, insufficient training of personnel and weak incentives facing decision-makers in the system.

It is on the basis of these findings that WAEMU member states are undertaking reforms, seeking greater transparency and better budget management.

These reforms have been centred on the definition of roles and responsibilities in budget and financial management and increased transparency in processes for the preparation, implementation, oversight and follow-up of the budget. The improved legal framework is one aspect of system reform to address these areas; the creation of effective control bodies is another. Governments have also focused on publishing and

distributing comprehensive and reliable information on all financial activities of the state and other public agencies, and on training and motivating managers and staff to be neutral and objective in undertaking budget and financial management tasks.

In Burkina Faso itself the desire for continued progress and a systematic approach to reform was expressed before the legal reforms were initiated. This came after the Department of Economics and Finance initiated its own review of the budget management system at the end of 2000. The first appraisal was carried out internally and was supplemented by external appraisals, specifically the joint Country Financial Accountability Assessment report and the IMF report on the Observation of Standards and Codes.

On the basis of the internal and external reports, finance ministry prepared an action plan for the reinforcement of budget expenditure management for the period 2002–2004. This report took into account:

- the importance of rationalising the administration and management of the structures involved in budget control
- the need to reinforce discipline and transparency in the execution of the budget by means of a suitable reorganisation of the legislative and regulatory system and effective application of the enacted rules
- the search for better programming of expenses to ensure appropriate budget choices
- the need to pursue the optimal mobilisation of internal and external resources to finance the poverty reduction strategy action plans
- the relevance of having a reliable budgetary and financial information system
- the urgent need to strengthen the audit system and the obligation to account for the management of public money.

The action plan constituted a benchmark framework for carrying out priority reforms to improve the transparency, reliability and effectiveness of budgetary control on a sustainable basis. In terms of the plan, government has undertaken important institutional and structural reforms and introduced management tools which have had a positive effect on the quality of budgetary control.

The programme budget

One example is the programme budget, which was set up in Burkina Faso in 1997. Although based on the Canadian model, the initiative came mostly from the MEF, supported by the World Bank. The programme budget approach modifies

the procedure for the preparation of preliminary draft budgets from an inputs perspective, to one which focuses on the objectives of spending. But this does not affect the presentation of the state budget in receipts and expenses. In the beginning, government piloted the reform in six ministries¹ before extending it to all ministries in 2000. Despite the good results achieved in some ministries, the approach did not become properly established across government because of the legal status of the instrument and an insufficient number of agents trained to implement it. Another factor was that ministries could afford not to pay too much attention to the programme budget. They remained focused on the traditional finance law instead, as it still formed the basis of all budget execution and scrutiny mechanisms and discussions in parliament.²

The MTEF

A second example is the introduction of medium-term expenditure frameworks (MTEFs). In Burkina Faso, the first MTEF was drawn up in 2000 to reinforce the implementation of the programme budget approach. In 2003, the MTEF was appended to the preparatory documents of the budgetary law. The MTEF, however, has not yet fully matured as a supporting instrument for multi-year programme-based budgeting. For one, there is no agreement between the forecasts of the table of financial transactions of the state, the MTEF and the finance law. The allocations listed in the finance law are always systematically higher than those envisaged by the MTEF, indicating insufficient attention by government to the proposals of the MTEF. Moreover, the MTEF does not present financial allocations by programmes, but only by ministry and budgetary titles, in other words, rigidly adhering to the budget structure in force.

Sector strategies

A third example is the development of sector strategies. For some years, multi-year sectoral policies have been developed in priority poverty reduction sectors, setting out results-based frameworks. These plans make it possible to link the multi-year nature of the actions and programmes to budget allocations, which are annual.

Overall, there have been significant improvements, a conclusion which is widely shared by the principal partners in development.³ The shift in aid management modalities, which was piloted within the framework of the Strategic Partnership for Africa (SPA), has also contributed to improved medium-term budgeting. Budget support is now the favoured modality and new types of conditionalities have been piloted.

Legacy systems and reform in Burkina Faso

However, despite this success, a number of features of the legacy system have hampered the embedding of a medium-term, results-based approach to budget management. Key among these is the legal status of multi-year results-based budgeting instruments. Others are weak forecasting capabilities and the absence of mechanisms for key budgetary process actors such as parliament to scrutinise programme-based budgets, legacies of the principle of annuality and weak parliamentary oversight of budgets in the francophone system. We investigate two further factors in more depth, namely the typically francophone system of budget execution and the separation of budgets.

Roles and responsibilities in the budget process

Viewed from the perspective of fiscal control, two main strengths of the francophone system are that there are clear roles and responsibilities in the budget process, and that the finance ministry is central to budget management. The question is whether these features support a medium-term perspective at all levels of the budget.

The MEF plays an important role all along the budget chain, from preparation to execution, including the audit. While sectoral ministries' objectives are to formulate policies and identify sectoral priorities, the MEF has authority over the budget allocation and control. The MEF:

- fixes ceilings for expenses
- arbitrates on budget appropriations
- is responsible for the control and regulation of expenses.

In Burkina Faso, spending ministries and institutions submit their financial requirements to the MEF in the form of projects and programmes. The MEF arbitrates between competing claims, using national priorities as the criterion. In this context, given the existing medium-term features of the French system, the Burkina Faso system has adapted well to a medium-term approach. Ceilings – or spending envelopes – are then allocated to each ministry or institution which must downscale its activities according to the financial constraint. Medium-term planning can be undermined, however, when these envelopes are adjusted during the year because of revenue shortfalls.

The MEF's control over the budget includes budget execution. Spending administrators (or initiators of spending) are based in the spending ministries. They initiate the expenditure process by indicating commitments that are to be made. Other budgetary players based in the spending ministries but working for the MEF are the payment authorising officers, financial controllers and accountants. A key

feature of the Burkina Faso – and indeed French – system is the strict separation between the role of payment authorising officer and the accountant. The financial controller actually represents the ‘eye of the finance minister’ in a sector, ministry or institution, which, according to several spending ministries, constitutes an obstacle to the implementation of projects and sectoral programmes.

In the French system, while there are significant budget control benefits to the multiple checks and balances, budget execution is complex, time consuming and largely outside the control of sector ministries. (See Box 2.2.1 for a description of the phases of budget execution.) This limits the capacity for medium-term planning and strategic use of resources. In addition, the sharp focus on financial compliance, while necessary, is at times at the expense of a focus on the policy results of spending.

Separation of budgets

Capital and operating expenditure budgets are separate in francophone countries. The practice is entrenched and presents advantages and disadvantages for multi-year budgeting.

In general, operating expenses are provided for and executed over one year. However, capital expenditures can be the subject of budgeting over one or more years. In theory, the advantages of distinguishing between capital and operating budgets are:

- grouping together investment plans
- facilitating the checking of the coherence of the programmes with the implementation of government policies
- greater clarity on investment implementation.

However, these advantages are only realised if proper appraisal processes and capacity and monitoring mechanisms exist, commensurate with a separate budget. This is rarely the case.

Another potential advantage is the greater control of government operating expenses, in line with the concern of ensuring that domestic own resources are not entirely used for the recurring expenses of the country to the detriment of creative capital expenditures for economic growth. Clearly, separating operating and capital expenditure makes it possible to determine with clarity how much of the domestic own revenues is absorbed by operating expenses. However, that is only true if the economic nature of all spending in the operating budget is recurrent, and capital on the capital budget side. This means that donor-funded recurrent costs should be recorded in the operating budget, and not in the capital budget as is too often the case (confusion of capital investment and ‘development’ budgets).

Box 2.2.1: Budget execution responsibilities in Burkina Faso

The execution of the operating expenses must contribute to stabilising public finances, which in turn supports medium-term planning for growth and development. In Burkina Faso the procedure for execution of operating expenses stretches over two phases: an administrative phase and an accounting phase.

In the administrative phase four actions are undertaken: commitment, verification of the service, settlement and payment order issuance. These actions are defined in the system as follows:

- **Commitment**: The financial system law specifies in Article 114: 'commitment is the act by which an agent of the administrative agency entitled for this purpose creates or records against the state an obligation from which an expense will result'.
- **Verification of the service carried out**: To really create the obligation, a service needs to be delivered. A necessary step therefore is verifying that the service has been carried out and that a debt has been created.
- **Settlement**: This step finally notes or stops creditors' claims against the state. It occurs through the verification of the debt and fixing the amount. Settlement occurs only after certification of the service carried out.
- **Issuance of the payment order**: In terms of Article 129, scheduling is defined as 'the administrative act whereby the payment authorizing officer gives to the accountant the order to pay a settled debt payable by the state'.

When all these steps are complete, it results in the establishment of a payment order. However, certain isolated expenses may be executed without issuing a payment order. (These would include civil or military pensions, and court fees.)

The accounting phase of the execution of the expense intervenes after completion of the operations of the administrative phase. Payment is the action whereby the administration is released from its debt through the transfer of money. It is carried out by the principal accountant using the following procedures: handing-over of cash, cheques by the treasurer, bank transfer or postal transfer. Before actually making the payment, the accountant must make sure that the payment received is legal, by requesting that the creditor receiving the payment provides formal proof of payment. In addition, the accountant must carry out an audit on the legality of the payment order. In the event of irregularity, the accountant can refuse to pay. Once a payment is made it can be recorded in the accounting system.

The disadvantages, however, are significant. The separation of budget inputs by type of spending results in rigidity of execution, which often leads to overspending of the operating budget, while the capital budget is often underspent. With multi-year allocations and credit carry-overs on the capital side, there is not the same urgency to get ongoing projects to spend an annual allocation. It also results in weak budget coherence, as the joint strategic purposes behind both capital and recurrent

spending do not become visible easily in budget allocations, and are as a result easily undermined.

2.2.3 Implications of multi-year budgeting

A consideration of implications of the francophone system for multi-year budgeting would be incomplete without a commensurate consideration of the implications of multi-year budgeting for the francophone system. It is precisely where the francophone system most hampers medium-term planning and budgeting, that the greatest need for reform of the francophone system can be found.

First, there is the need to reform the legal framework, both in terms of legislative instruments (organic laws and budgets laws) and regulatory instruments (decrees, orders). One could, for example, have framework laws for three or five years and finance laws for one year. It is important to note that multi-year budgeting means a repositioning of the principle of annuality for recurrent spending in the francophone system. The legal framework for budget documentation is one area in which reform may be needed. In Burkina Faso the informative value of multi-year programmes can be improved by providing more disaggregated data. In fact, these programmes are not accompanied by accounting appendices clarifying the assumptions which determine their evolution, limiting their effectiveness. However, a key challenge is to make these type of documents legal instruments, thereby influencing real budget decisions.

Many countries, including France, now present spending plans with close linkages to the objectives of spending. In many countries, budget documentation shows the expected results of spending, consistent with government's strategy. While this kind of programming may present significant difficulties in practice, such as designing a coherent non-overlapping programme structure and overcoming the complex relationships between administrative budget holders and programmes for accountable budget execution, the result is a more transparent budget structure and better incentives for strategic spending.

Second, there will have to be institutional adjustments in the distribution of roles and responsibilities. Countries will have to set up appropriate structures for implementing multi-year budgeting.

Third, there will have to be a reconsideration of result-based management modalities. In the francophone countries generally, results targets are not linked to expenses, as expenses are effected annually whereas results are related to multi-year timeframes. With budgets shifting to multi-years, there will be more scope and need for countries to present results data in budgetary documents, linked to expenses.

Fourth, the strict separation of programme management and service delivery and

financial management roles may need to shift. This would also imply more authority for managers to use global budget allocations towards their strategic targets. Of course, this would need to be linked to greater accountability for and greater transparency in the results achieved.

Finally, there would need to be much greater engagement with forecasting activities, of both a financial and non-financial nature. At the economic level, multi-year budgeting satisfies the concern that current national and international economic circumstances and national economic policy should be taken into account. How effectively this can be done is dependent on the quality of forecasting. There are several interdependent levels of forecasting: macroeconomic variables, revenues, sector policy variables and related expenses of ministries and institutions.

2.2.4 Conclusion

The budgetary model in force in the francophone countries of West Africa (the one that WAEMU directives are based on) derives from the French model captured in the 1959 ordinance. Significant reforms have been undertaken in these countries, among them the reform of legal frameworks to take WAEMU directives into account and the introduction of medium-term expenditure frameworks. While there are obstacles to overcome before significant benefits from modern budgeting reforms can be realised fully and while many of these obstacles arise out of an embedded francophone budgeting culture, the francophone system also offers clear benefits for getting the basics of budget control right, as well as some existing multi-year practices that could improve multi-year budgeting approaches elsewhere.

2.3 Legacy systems and budget reform: The case of Kenya

Kubai Khasiani

2.3.1 Introduction

Kenya's economy performed well after independence, maintaining an average annual growth of 6.4 percent over the period 1964–1972. However, this growth declined to 5.2 percent between 1974 and 1979, 4.0 percent between 1980 and 1989, and 2.4 percent between 1990 and 2000. Up to 2003, the economy had been performing below its potential, with low economic and employment growth and a decline in productivity.

This slowdown in performance can be attributed to a number of factors, including the existing public financial management systems, and the processes and the institutions in place. The 1995 Public Expenditure Review revealed that there was generally low budget credibility, a position reflected in the increasing variance between the budgeted and actual expenditures. Further, capital spending was showing a declining trend, culminating in large arrears and budget overruns in some ministries. An interesting aspect, however, was the increasing trend in underspending in other

ministries, which at the time was attributed to a low absorption of donor funding and unpredictable releases from the exchequer. But subsequent reviews revealed lack of transparency and comprehensiveness in the budget; poor control in budget execution including accounting and reporting; weak audit and parliamentary oversight; and ineffective use of external development assistance.

To address these problems the Kenyan government introduced the medium-term expenditure framework (MTEF) in June 2000 as an instrument and process for reforming its public expenditure management system. The MTEF was also meant to increase stakeholder participation in setting national priorities; improve expenditure prioritisation, transparency and accountability; and achieve enhanced service delivery. In this way it would restore the credibility, predictability and effectiveness of the budget process.⁴

An assessment of the systems prevailing before the introduction of the MTEF, the assumptions on which the new instrument was based and the current workings of the budget system in relation to the expectations, provide an opportunity for an examination of the role the financial management architecture has played in realising the ideals of a medium-term perspective of budgeting.

This paper therefore reviews the influence of the budget systems that have prevailed in Kenya since independence on public financial management reform. It assesses the impact of the reforms that have been introduced over time against this background. Specifically, the paper focuses on the difficulties of harmonising the MTEF as an institutional reform with the inherited systems.

2.3.2 Legacy systems and the medium-term expenditure framework

Certain fundamental democratic principles apply to the control and management of public funds in central government, including in Kenya. These include that the state shall be based on democratic principles, which empower and encourage the active participation of all citizens at all levels in their government and that the people shall be governed by their will and consent.

When these principles are translated into questions around the governance of the people's money, the following questions relating to the legal framework for good public finance need to be asked:

- Separation of powers: What is the relationship between the executive and the legislature?
- Duties and responsibilities: Who is responsible for what and when?
- Accountability relationships: Who is accountable to whom (the treasury, parliament, the accounting officers, the presidency, the citizenry) and when?

- Transparency: What frameworks of transparency are necessary in this kind of democracy and how can they be provided for?

In Kenya, the legacy of the underlying public finance management legal framework and the systems that evolved from it have, over time, contributed to undermining the achievement of good public finance management and spending effectiveness. This paper examines this in a number of key areas to look at how they are underpinned by the legacy legal and management systems, and in turn how they are being addressed in the reforms that have been introduced since the early 2000s. These are: (i) the role of parliament; (ii) budget preparation and the legal framework (iii) decentralised budget execution and accounting; (iv) the accounting systems and the availability of up to date financial information; (v) the function of the auditor-general; (vi) internal controls and issues around the closing of the financial year; and (vii) legacy donor systems. The paper will show how these issues – by no means a comprehensive list – have affected public spending outcomes in Kenya.

Role of parliament

The democratic system in Kenya is based on the Westminster history and philosophy. This is rooted in the understanding that,⁵ ‘The Crown demands money and the Commons grant it. However, the Commons do not vote money unless it is required by the Crown; nor do they impose or augment taxes.’ The role of parliament is therefore very clearly entrenched in the principle of ‘no taxation without representation’. This principle presupposes that as representatives of the people, members of parliament give permission for taxes to be imposed, but do not raise them. Similarly, parliament gives permission for expenditures to take place, but does not determine them.

The Kenyan Constitution sets out the basic framework for the accountability relationship between the legislative and executive arms of government with regards to the budget.

Hybrid system with parliamentary and presidential features

Much of the current constitutional system was inherited when Kenya achieved independence from the UK in the 1960s, but the system also borrows from the presidential system of countries such as the USA, where the president is directly elected and is head of the executive as well as head of state. In Kenya the head of the executive is a directly elected president, though some aspects of a Westminster parliamentary system are still in place. Members of parliament are directly elected and the cabinet consists of ministers appointed by the president from members of parliament.

Box 2.3.1: The Kenyan legal framework for public finance management

The current Constitution in Kenya is by and large the same as the one negotiated and granted to independent Kenya by the British with regard to the legislation guiding public finance management. The 1963 Constitution was a replica of the UK model with the queen holding the reins of the head of state. However, in 1964 Kenya opted for internal self-government, which led to the Constitution of the Republic of Kenya. Before the adoption of the republic, there was a brief debate about whether the country should adopt a decentralised form of government but Kenyans voted for a centralised, unitary republic.

Public finance management in Kenya is governed by the Constitution and various other acts of parliament. The constitutional provisions are to be found in Article 48 and Chapter 7 of the Constitution. In essence the provisions divide responsibilities for finance between the legislative and executive branches of government. In summary, it requires the executive to seek the prior permission of the legislature both to raise and spend money while restricting the legislature from initiating revenue or expenditure without the prior permission of the executive.

Subsidiary legislation was based on the long established tradition of an annual line item, an incremental approach to public financial management and established procedures and accountability processes on this basis. Originally, this consisted largely of the Exchequer and Audit Act, which had its genesis in colonial times.

This was revised and updated by the introduction of the Public Audit Act in 2003, the Government Financial Management Act in 2004 and the Public Procurement and Disposal Act in 2005, which address specific aspects of the public finance management system.

The two systems on which Kenya's structure of state is based, however, have significant differences when it comes to the budgetary process. As observed by Lienert, 'In presidential systems the annual budget encapsulates the legislature's wishes with respect to taxation and expenditure policies. The United States is a prime example of this form of government. Both houses of the Congress have unfettered powers to amend the President's draft annual budget.'⁶ The United Kingdom is at the other end of the spectrum. In a parliamentary monarchy of the 'Westminster' type, the leader of the main political party is both a member of parliament and the effective head of the executive branch. Within government, the budget-making powers of the prime minister and his/her cabinet of ministers are very strong. By tradition, the head of state follows the advice of the ministers. In budget-making, parliament is virtually totally subservient to government. Or as the UK government's own accounting manual puts it, 'In practice, on questions of finance the influence of Ministers normally reduces the House's power of control to a right to criticize, exercised chiefly by the Opposition.'⁷

In separating the role of parliament from the executive in public finance management, the Westminster model provides for parliament to approve policy

in legislation while the executive requests funds annually from parliament in the estimates, to finance those approved policies. Parliament scrutinises these requests and approves the issue of funds by an appropriation act. Parliamentary practice provides for a process in which the parliamentary committee of supply annually approves specific items of expenditure for appropriation. Parliament does not have powers to amend government's spending proposals: it can merely reject them, thereby bringing the government down. Parliament's greater power lies in the scrutiny of annual accounts through its public accounts committee through which it makes recommendations to the executive for implementation.

The involvement of parliament in the budget preparation process is therefore limited to a final stage when completed estimates are delivered for approval. Though there are provisions for downstream budget information (on how funds were used) to be supplied to the legislature by the executive, there is little or no requirement for any up front information to be supplied in respect of the budget context, presumably on the basis that the context was an annual one. There is therefore also generally poor follow-up on the oversight of actual spending since weak engagement at the budget approval stage means weak incentives for spending agencies to heed parliamentary recommendations arising out of the public accounts committee's work.

New legislation gives parliament more say in budget process

In Kenya, parliament has sought to break away from this Westminster tradition by proposing legislation, the draft Fiscal Management Bill, to have increased influence in the budget prior to its approval. This comes after two prior acts which broke with the traditional system of parliament not proposing spending. The enactment of the Parliamentary Service Commission Act (PSC) in 1999 and the Constituencies Development Fund Act (CDF) in 2003 has resulted in a violation of the principle of separation of powers between the legislature and the executive. The PSC Act provides that parliament can prepare and approve its own estimates of expenditure, contrary to the constitutional provision on separation of powers by which only the executive could initiate expenditure measures. Similarly, the CDF Act provides for a set amount of revenues to flow to a fund in terms of which projects are initiated and executed within constituencies. Controversially, it also provides for the involvement of the legislators by legally empowering them to chair the committees that manage the funds within their constituencies, an obvious conflict of interest. These developments have been interpreted to confer both legislative and executive responsibilities on the legislators.

In a related initiative, parliament recently created a budget office in response to poor information provided by Treasury on the budget, to assist the members in

interrogating the budget. It is now seeking to entrench the office in law and give it powers to draft an alternative budget, in case parliament is dissatisfied with the budget presented by the executive. This attempt by parliament to have more control over the budget process in Kenya borrows heavily from the US system, which gives the Congress powers to draft an alternative budget. This makes parliament even more powerful and intrusive and directly interferes with the power conferred on the executive (Treasury) by the Constitution to craft and present a national budget to the national assembly.

These initiatives by parliament are the result of tensions arising from the hybrid parliamentary/presidential system and a wrestle for control of the purse, but also a reaction to the perception that the role of the executive is too strong in budget management, undermines effective parliamentary checks and balances, and leads to poor accountability. However, insufficient attention has been paid in the drafting of the legislation to the need for a strong, unitary and comprehensive budget system. Also, they are unlikely to overcome the significant existing inherited challenges: instead they may exacerbate the effect of these challenges on effective spending through further weakening of accountability systems.

The challenges include the thin separation of powers that comes with a parliament whose members are also ministers even when full budget making powers rest with the executive and the structure; increasing the budgetary powers of parliament will not overcome this weakness.

Constraints to implementing medium-term approach to budgeting

Another concern is the annual and input focused nature of the budget under the appropriations bill – as per the standing orders of parliament – which is similar to the UK precedent. This caters more for administrative accountability than policy accountability. This provision is a constraint in the quest to transit to a programme based medium-term approach to budgeting as parliament cannot legally approve the budget for more than one year, nor can the budget be programme based. For parliament to approve the budget at programme level, it would need to be able to fully interrogate the budget ex ante and be comfortable that the programmes are in line with the overall government goals and the specific sectoral objectives. Currently the budget framework does not identify the overall national goals nor does it specify the sectoral objectives. As currently constituted, the Kenyan budget is not transparent and has limited room for accountability. This situation also calls for a review of the global legislation to provide for more transparency and accountability in the budget process, not only for reforming the legislative phase.

Also, in addition to the PSC and CDF acts, there has been an accumulation of

legislative measures that earmark revenues for specific expenditures, resulting in a large percentage of non-discretionary expenditures not being part of the common pool which funds priorities. These measures came into the system as a consequence of the failure to develop a strong, central budget allocation system in which contestability is high and its early anchoring in legislation. The measures have also had the effect of threatening the ability of the finance ministry to develop a sound, comprehensive fiscal framework.

Issues around budget preparation and the legal framework

The Kenyan challenges discussed above arise partly because – in keeping with the Westminster tradition – the global budget management legislation was focused more on the separation of powers during execution and on ex post oversight, with thin regulation on budget preparation. Budget preparation is traditionally regulated through annual circulars, a much weaker legal instrument. Coupled with an input-based accountability framework, this has had an adverse effect on the level of prior involvement of major stakeholders in the budget process. It has also created the policy space for alternative initiatives that are often narrow in their interest and not sufficiently focused on the creation of a strong, disciplined and unitary budget process.

Even if not embedded in legislation, the budgetary systems in Kenya have evolved over the last 45 years. This has happened in an incremental way without any radical transformations. During this time the country has consistently attempted to reform its systems in line with changes and requirements for good public finance management. As a result of numerous reform initiatives, the current process for preparing the budget has thus evolved from a purely finance ministry based function to a highly inclusive and participatory process. The current budget preparation is therefore more inclusive and consultative.

The MTEF approach is increasingly being adopted by many developing countries as the preferred mode of budgeting. Kenya adopted the MTEF as a broad approach to integrating policy-making, planning and budgeting. The approach is a means to provide certainty and consistency in funding for ministries and a tool for enforcing government to stick within its overall budget (aggregated hard budget constraint), while allowing for flexibility. The MTEF is predicated on certain conditions that enable it to function. These include availability of information on accurate costs of government policies, programmes, sub-programmes, activities, projects, outputs and outcomes. The MTEF should also ideally be anchored in ‘rules of the game’ such as: mechanisms at cabinet and ministerial level to make trade-offs; rule-based relationships between the finance ministry and line ministries; and clearly defined

political versus managerial accountability. An MTEF requires the budget to be comprehensive and cover all government transactions including current off-budget funds.

However, specific issues have constantly dogged public finance management in Kenya and have subsequently impacted on the introduction and implementation of the medium-term expenditure framework.

Lack of budget comprehensiveness

Lack of budget comprehensiveness is evident in the existence of autonomous bodies, extra budgetary funds, quasi fiscal activities and government guarantees outside the budget framework and process. This has a negative effect on multi-year budgeting as a substantial part of the budget resources is off budget.

Lack of contestability for resource allocation within the budget

The budget has not embraced the principle of contestability within a hard budget constraint. A hard budget constraint is a necessary condition as it ensures competition for resources by both existing and new programmes. Another condition is comprehensiveness. If policies are to compete, all claims should be presented on an equal footing when allocations are made. A third condition is that there should be explicit linking between policy planning and budgeting over the medium term: this has been absent.

Lack of a credible model for budgeting

A credible model for determining priorities enhances transparency while addressing the identified needs. Transparent rules for determination of expenditure priorities, the resource envelope and trade-offs are crucial principles in public expenditure management. Anglophone countries have traditionally structured their budget on an input-based itemised framework, which fails to promote the prioritisation of programmes. In this regard, a number of countries are now adopting a programme budget model which provides the capacity to measure outputs and progress against policies, thus providing the framework for transparency, contestability and accountability. Kenya upgraded the line-item classification system to a modern government financial statistics (GFS) compliant system in 2005. It has, however, not yet implemented a programme budgeting system fully, partly because the parliamentary standing orders still require an input-based budget format. This undermines efforts to shift budgeting models to plan for results, rather than incremental increases in inputs.

Flexibility in resource allocation

The budget is traditionally framed on an inflexible framework that provides for variations only on the authority of parliament. While a good budget should have limited variance between the plan and the outcome, the operational environment is dynamic and thus a certain measure of flexibility for the implementing agency needs to be inbuilt in a credible budget. Kenya follows the anglophone system, which empowers the accounting officer to incur expenditure only on the items parliament has approved. Any variations must be referred to parliament for approval, thus undermining the capacity of an implementing agency to deliver on agreed programmes.

Dual budgeting

The current budget is a dual budget prepared as capital and recurrent budgets. In Kenya the capital budget is prepared on the basis of programmes proposed through sector working groups. Capital funding is allocated based on an agreed macroeconomic model, which simulates the fundamentals that are critical for the desired growth. In practice, recurrent budget allocations are still arrived at based on historical costs, current government institutional needs and the balance remaining after providing for non-discretionary expenditures (including salaries and wages) and the capital budget. This is not ideal as the process does not reflect on the expected outputs of a department. These two budgets are prepared as if they are separate and independent of each other, resulting, among others, in the medium-term recurrent requirements of the capital budget not being catered for in the recurrent budget.

Lack of strategic plans

Although the anglophone countries have a tradition of preparing national development plans, it is unfortunate that despite the existence of these broad spectrum strategies, individual ministries, departments and agencies (MDAs) have been weak in preparing and implementing strategic plans that are consistent with the overall country objectives. This can be attributed to the nature of budgeting being highly input based and incremental and not requiring the crafting of strategic plans, proper costing or much strategic decision-making. Despite significant efforts in Kenya to institutionalise the preparation of ministerial public expenditure reviews and sector working group reports, both aimed at the development of sector level plans, the quality of the resulting documents has been variable and often poor. It is only in some sectors with significant external support that comprehensive, credible plans have been produced.

Lack of political ownership

The introduction of the MTEF in Kenya was initially highly acknowledged at a political level. Indeed the change received cabinet approval and was launched with much fanfare. However, subsequently there has been a lackadaisical approach and low buy-in at the political level, leading to slow realisation of the benefits of the reform. This is generally true of most of the budget reforms and their effectiveness in anglophone countries. In cases where a reform is politically undesirable, the political level, with ministerial powers over policy-making, does not lend its support in practice, and more often than not stalls implementation.

In Kenya, the progressive budget reforms are moving towards a programme structure, which in turn will facilitate a performance orientation in budgeting. One of the aims of this reform is to increase political ownership, since the link between policy – a political responsibility – and spending would become clearer and create more incentives for political office holders to engage meaningfully with the budget. Already, there is a framework to instil a performance culture in the public service with the introduction of performance contracting.

Issues around budget execution

A good public finance management system operates best within a legal and operating structure that is associated with good financial governance. Key structures and institutions need to be in place and empowered to operate efficiently and independently within the framework, and have to be supported with trained personnel and resources. A good PFM depends on both the institutional framework and working systems. Necessary authorities for decision-making should be in place to avoid duplication of roles and remove conflicts.

The accounting process

As in many anglophone countries, budget execution and accounting are line ministry functions in Kenya. Parliament directly appropriates funds to a line ministry under a vote and the accounting officer is therefore responsible for executing the budget. The Treasury, however, has supervisory powers over the budget management while ministries retain accountability and reporting. It is the responsibility of the Treasury to project and source for revenues and to provide for expenditure limits for the entire government. Accounting units may therefore not seek for financing outside the approved budget and shall not spend in excess of the limits provided.

In Kenya the treasury function is identified under the accountant-general, who has delegated staff to the MDAs to carry out the function. This function is, however, not

strictly delineated from the authorising function as both the authority and payments are done at the MDA level, with the accounting officer delegating the authorising function to an implementing office while retaining overall charge of both the treasury and the payment authorisation functions.

Some of the positive factors arising from the anglophone system include:

- The accounting officers have powers to implement the budget within the guidelines given by the treasury but may not incur expenditure outside the parliamentary approval.
- Powers for virement (adjusting the budget during the year) are delegated to accounting officers at the sub-item level. However, any virement at the principal item level (levels at which parliamentary approval is provided) can be allowed only by the Treasury and will need to be formally approved by parliament.
- This provides a certain level of flexibility to the accounting officers in varying expenditure and determining payments as necessary.

This arrangement also has its shortcomings:

- It removes control from the national finance ministry as opposed to a situation where all the payments are made from a centralised point.
- There can be a proliferation of payment arrears and in some cases, stalled projects arising from failure by MDAs to meet their obligations in time.
- The lack of fiscal discipline results in the sub-optimal utilisation of public resources; Kenya's current public finance management architecture has been affected adversely by fiscal indiscipline. Spending agency control over budget execution without commensurate control measures has contributed to increased fiscal indiscipline.
- There is no separation between the treasury and the payment functions, which poses a threat to control.

The financial year

The legal provision for one-year budget authorisation is embedded in law and this is only granted by parliament. Without the amendment of this principle to provide for a multi-year budget the MTEF concept is undermined. Some of the consequences include the inability to carry over the funding from one year to another, and in practice annualised programming that tends to negate the MTEF.

Annual accounts and the reporting system

Locating accounting responsibility at spending unit level has affected financial reporting. Some of the consequences of making payments at the spending units and reporting on a regular basis to the national treasury include the following:

- Annual accounts are perpetually delayed and parliament is not empowered to oversee the outputs of government within the stipulated time.
- Delays in regular in-year reporting result in low-value financial and managerial reports that do not assist in decision-making.
- The books of accounts, including the vote books, are poorly kept with inaccuracies and manipulation of the records.

The ongoing introduction of an integrated financial information system, along with other reforms to address the weaknesses of a manual process, is expected to speed up the reporting and the audit process and improve the quality of information.

Internal controls and the internal audit system

The internal controls within ministries are standardised and regulated from the office of the accountant-general. Similarly, internal audit officials in Kenya are based within ministries, but are also controlled from the finance ministry. This system has the advantage of having uniform standards but is often seen to have the negative effect of being imposed on the accounting units. The result is that the controls are not owned by the accounting units and the advice from the internal audit is negatively interpreted as being punitive rather than aimed at improving financial management.

The staff system

In Kenya, a central commission manages all government staff. This denies accounting units the flexibility to hire and fire. This is an anglophone legacy and has a direct impact on medium-term planning and budgeting as the units almost always carry staff complements that are not consistent with their mandate and programmes. Relatedly, salaries and wages have been a first charge against available revenue within the recurrent budget: a logical counterfoil for staff being centrally appointed. Wage negotiations are also managed centrally. The situation has made it very difficult for a medium-term projection of the budget to be determined reliably. In order to have a reliable forecast of the budget, a wage policy that is consistent with the macroeconomic framework is absolutely necessary. In order for ministries to assess the true cost of providing services and making trade-offs, some control over salaries is required. In the absence of such mechanisms, salaries become a funding element that is less contestable at central and spending agency level.

Issues around the role of the auditor-general

The controller and auditor-general audits the annual accounts on an annual basis and reports to parliament. He/she has tenure of office, is sufficiently independent and his/her budget is not censured by the finance ministry. However, he/she has a duty to give approval for any exchequer cash releases to be made from the Consolidated Fund on satisfactory confirmation that the withdrawal is consistent with the budget approved by parliament. This system is inherited from the British system of the last century and gives the holder of the office an executive role, a matter which has raised questions regarding his/her independence in the audit process. This position was inherited from the independence constitution, which has not been reviewed to date.

Also, the current framework for auditing, which is consistent with a line item budget, puts more emphasis on compliance rather than outputs from the resource allocation. In order to report and audit against the medium-term performance, the budget framework needs to be changed to provide a programme based rather than a line item budget. This will enable value based audits, which are consistent with medium-term programmes.

Issues around donor management systems

The system for managing external financing has been supply based, with a very ineffective framework in place for the determination of the need for and optimal level of donor financing. This system has allowed for a number of consequences that affect the implementation of the MTEF. These include:

- the commitment of external resources on the budget without regard to the capacity for absorption, leading to a perennial case of low level of project expenditures
- the absorption of supply-driven resources outside the budget system circumventing the contestability of policies and the prioritisation of programmes and eventually undermining the sustainability of the MTEF
- incomprehensive budget with limited financial data and reports on the overall performance of the budget, including external financing.

On the positive side, there have been developments that support the restructuring of donor funding, including the institution of a consultative budgeting process that is sector based. Donors have embraced the new sector-wide approach, which lays out a framework for absorbing donor funding. Kenya is also in the final stages of publishing an aid management policy, which is expected to streamline the absorption of donor financing in the budget, thereby addressing medium-term planning and budgeting.

2.3.3 Conclusion

Kenya has constitutional provisions for its public finance management practice. However, over time the systems in place have been found to be less transparent and also lacking in adequate accountability mechanisms. The principles underlying the systems have also been under threat from informal processes and a weak constitutional base. Kenya does not presently have an organic budget law or legislation that entrenches public finance management in the Constitution.

A number of reforms have already been instituted with a view to address the challenges identified in this text. These include:

- An exercise to provide for a framework for capturing all public expenditures on the budget, notwithstanding the source of financing. This will be done by implementing the Kenya External Aid Policy coupled with a comprehensive study of all extra budgetary funds to bring all these expenditures on budget.
- The introduction of a treasury single account to avoid spurious expenditures funded from elsewhere and to facilitate the consolidation of the capital and recurrent budgets.
- Providing a framework for policy and budget contestability and providing for a framework for programme-based performance budgeting.

These reforms will greatly impact on the capacity of the system to implement a medium-term budget framework and help to break the effects of the inherited systems.

The constitutional weaknesses that have been described and which have made it possible for parliament to enact other subsidiary legislations to circumvent the principle of separation of powers and treasury superintendence in public finance management, call for an adoption of a comprehensive budget law to regulate the process. In conclusion, it is apparent that this key reform initiative in Kenya must be focused on how to entrench universal budgeting principles in a single framework.

However, developing such legislation is easier said than done. In its efforts to do so, Kenya faces key challenges.

First, what should the separation of powers be? While it is generally agreed that the budget process needs to be more transparent and that parliament should have access to information on the budget process, the Kenyan parliament is now seeking a bigger role in budgeting, prior to its approval. How much leeway should be given to parliamentary regulation without compromising separation of powers and the comprehensiveness of the budget process is a difficult question.

Second, enabling PFM legislation must address key weaknesses around medium-

term planning, budget execution discipline and quality, timely financial accounts effectively. Currently, due to the fact that the MTEF is not institutionalised it is seen as separate from the budget process and largely a technical exercise developed by the finance ministry. The lack of a global, effective institutional framework renders the budget vulnerable to manipulation and more often than not it tends not to be transparent.

The country is now working on an organic budget law (OBL) to address these challenges. The OBL is also expected to address the provision for a framework for multi-year budgeting by providing for the approval of a medium-term budget by parliament and thereby freeing the budget execution by annualised encumbrances. The OBL will further provide for more formalised inclusion of parliament in ex ante budget processes, the institutionalisation of strategic management and a strong fiscal perspective, all of which should help to address the unstructured approach to budget preparation. The OBL is in many respects not different from the proposed parliamentary fiscal management bill and in principle it should be better to have one comprehensive piece of legislation. The bill is therefore also likely to institutionalise the parliamentary budget office. The development of budgeting and financial management expertise in such an office will help provide guidance to the members of parliament on principles of sound budgeting, on updates to budget classification and the introduction of a programme budget. On an annual basis it can support accountability through consolidating information for parliament on budget proposals and execution.

Finally, the Kenya experience shows that the imposition of change on inherited systems affects the delivery of reforms, often negatively. In carrying out reforms there is therefore a need to take account of the underlying systems and their relevance, and address that first. Even more important is the realisation of the role of the legal framework in influencing the outcome of specific reforms. Ultimately, and recognising that the budget is a political document, it is a fact that the drive for change in the budgetary process is highly dependent on the political will, both of members of parliament and political office holders in the executive. A well-executed legal drafting process can create the necessary forums through which buy-in can be negotiated.

2.4 Inherited budget practices and medium-term expenditure frameworks in francophone and anglophone Africa

*Ian Liener*⁸

2.4.1 Introduction

This paper examines the inherited budget systems in francophone and anglophone Africa and the way they are applied in practice. The focus is on medium-term budget issues. In this context, African countries generally lay out government strategic priorities for economic and social development in coming years in documents such as national plans, the poverty reduction strategy paper (PRSP), and a public investment plan (PIP). These documents indicate a government's medium-term objectives for economic growth, inflation and monetary and fiscal policies, and are used for its discussions with the international donor community.

Increasingly, African governments formulate the annual budget in the context of

medium-term budget plans, consistent with PIPs and PRSPs. In particular, a medium-term budget framework (MTBF, which projects aggregate revenues and expenditures) and/or medium-term expenditure frameworks (MTEFs, in which overall and sectoral spending is projected over a medium-term period – typically three years) are prepared by the finance ministry and in some instances, endorsed by the cabinet of ministers and presented to parliament.

One aim of this paper is to examine legacy issues associated with the inherited budget systems. The overarching aim is to provide an analysis that is helpful for answering the following three questions:

- Are African countries moving to a more uniform budget system, especially with regard to MTBFs/MTEFs, given globalisation and donor pressure to adopt ‘best practice’ systems – the reforms of advanced countries that are perceived to be applicable to African countries?
- Are legacy issues constraining the introduction of MTBFs and MTEFs? If so, how should these reforms be adapted to ‘fit’ the inherited budget systems in francophone or anglophone countries?
- Are there other constraints (apart from legacy issues) that thwart the introduction of effective MTBFs?

To address these issues, the paper first examines ten principles of good practice in any budget management system, with a view to observing whether there are discernible differences between the francophone and anglophone countries, notably in: (a) the relative importance of each of these principles; and (b) the manner in which these principles are applied. After examining the diversity of the ways in which MTEFs are implemented in European countries (which could provide a benchmark for ‘modern’ practice), the experience in African countries is examined. Ten budget issues associated with MTBFs are then examined, in an attempt to isolate discernible areas where convergence is taking place between francophone and anglophone countries, or where the inherited budget systems may be inhibiting convergence of medium-term budget practices. Differing attitudes towards the role of law in promoting budget reform in the two country groupings are highlighted. The conclusions provide tentative responses to the three questions above.

2.4.2 Budget principles and practice in francophone and anglophone Africa

Importance of incorporating principles in laws and regulations

At least ten important principles undergirding the preparation, adoption and execution of the annual budget can be identified (Box 2.4.1). Francophone countries have inherited a strong attachment to the need to incorporate specific budget principles in law. This is not the case in anglophone countries.

Box 2.4.1. Ten important budget principles

1. **Authoritativeness:** Decision-making authority is specified for each stage of budget processes. The supremacy of the legislature in approving the budget is an integral part of this principle.
2. **Annuality:** Budget authority is provided for a 12-month period. The annual budget is enacted prior to the year to which it refers.
3. **Universality:** All revenues and expenditures are included in the budget on a gross basis. Revenues are not earmarked. Expenditures are not offset by revenues.
4. **Unity:** The budget presents, and may seek approval for, all receipts and payments at the same time, usually in the same document.
5. **Specificity:** Revenues and expenditures are shown with some detail in the budget estimates. Annual appropriations show legally binding maximum expenditures for specific purposes.
6. **Balance:** Budget expenditures are balanced by budget revenues and financing. 'Balance' is well defined.
7. **Accountability:** The executive gives an account of how it meets its responsibilities to the legislature. Within the executive, the accountability of budget managers is clearly defined. An independent external audit body reports annually to the legislature on budget execution.
8. **Transparency:** The roles of various public sector and government bodies are clear. Timely financial and non-financial information on the budget is publicly available.
9. **Stability:** Budget and public debt objectives are framed in the context of a regularly updated medium-term budget framework. The rates and bases of taxes and other charges are relatively stable.
10. **Performance:** The expected and past results of budget programmes are reported in the budget. The principles of efficiency, economy and effectiveness are associated with 'performance'.

Source: Table III.3, Lienert and Jung 2004

France's 1958 Constitution had a considerable influence on the constitutions of francophone countries. All of these constitutions contain important articles relating to budget *balance* (Box 2.4.1, Principle 6). Francophone countries generally simply copied the French Constitution's article that states that 'proposals or amendments by parliament will not be accepted if their adoption would result in lower revenues or an increase in expenditures'. In other words, parliament is prevented from adopting measures that would worsen the fiscal balance proposed in government's draft annual budget. This is a strong fiscal rule that enforces budget discipline, provided government itself is fiscally responsible and respects this constitutional requirement. (This is not always the case.)

The French Constitution and many francophone African countries' constitutions also have strong constraints on parliamentary power. For example, Togo's Constitution allows government to adopt the annual budget by ordinance if the national assembly does not adopt it within 45 days after the submission of the draft by government (Article 91). This copies the unique feature of France's 1958 Constitution that requires parliament to adopt the annual budget before the start of the new fiscal year. More generally, France's 1958 Constitution and all francophone African countries provide for strong *authoritativeness* (Box 2.4.1, Principle 1) of the executive. Presidents in francophone Africa are provided with strong constitutional powers. Anglophone countries' presidents, too, benefit from strong constitutional authority, a reflection of the weaknesses of parliamentary powers in the United Kingdom. (Lienert 2007 elaborates on this for the case of Tanzania.)

Francophone countries in Africa have also copied the French Constitution's requirement that the national assembly adopts annual budget laws according to an organic budget law (OBL) governing budget processes. There is no such equivalent in anglophone countries.

Accordingly, francophone countries have generally adopted an OBL, which incorporates the principles of *annuality*, *universality*, *unity* and *specificity* (Box 2.4.1, Principles 2–5). These are considered fundamental, along with the principle of the separation of the budget authorising officers (*ordonnateur*) and public accountants. The paper on Burkina Faso presented in this volume traces the origin of the WAEMU 1997 directives and the laws adopted in the eight member countries of the West African Economic and Monetary Union (WAEMU) to the organic budget legislation adopted in France in 1959. These now outdated laws relate particularly to budget preparation. The 1959 organic ordinance contained few provisions on parliamentary adoption of the annual budget (but note that time limits for parliament to adopt the budget were included in the Constitution) or on budget execution, for which complex procedures are specified in regulations in francophone Africa.

In contrast, in anglophone countries, it is possible to change the budget system without changing any supporting laws (for example, public finance acts). Unlike in francophone countries, there is no need to adopt new laws or regulations to introduce budget reforms; if needed, the law can be changed later to support the reforms.

Nonetheless, after independence from the United Kingdom – and unlike the former colonial power – anglophone African countries adopted written constitutions. Since the budget system practised in these countries in the 1960s was based on that of the colonial administration, some of the principles of the British system were incorporated into constitutions. In particular, the principle of *universality* – expressed for budget expenditures to be paid for from a consolidated fund (into which all revenues were to be paid) – is embedded in the constitutions of several anglophone African countries.

In anglophone countries, the principle of *accountability* of accounting officers – senior civil servants who are overall managers of ministries' budgets – before the public accounts committee of parliament is stressed in law. This principle is supported by the establishment of an office of the controller and auditor-general, who is responsible to report to parliament of shortcomings in budget practices. Public finance acts often combined provisions for both the budget management and external audit functions.⁹ In francophone countries, spending ministries and cabinet ministers other than the minister of finance have been given very few responsibilities. *Accountability* in these countries has, in principle, been concentrated on the public accountants, who, according to regulations in place (based on France's 1962 public accounting regulations), are responsible for defending their annual accounts before magistrates of the court of accounts, who pronounce judgements on the accuracy of the financial accounts of whole-of-government. However, in practice, courts of accounts in francophone countries were either not established when the regulations were adopted (although sometimes accounting sections under the supreme court were established for the same purpose), or they were so weakly provisioned in human and material resources that their ability to perform their mandates was seriously undermined (Lienert 2003; Moussa 2004).

In both francophone and anglophone countries, the budget principles of medium-term *stability*, *transparency*, and *performance* (Box 2.4.1, Principles 8–10) have traditionally been downplayed or even ignored, at least until recently – as discussed later in this paper.

Application of laws and regulations in the two regions in Africa

In francophone countries, the entire legal framework: the Constitution, organic budget laws, annual budget laws and public accounting regulations (which also lay out responsibilities of *ordonnateurs* and public accountants) are crucial. This contrasts

with anglophone countries, where a more laissez-faire approach is taken towards law. Irrespective of the relative importance of law, a crucial question is: Are laws and regulations respected?

The respect of law in any country requires well-functioning institutions, including an independent judiciary, an active parliament, a free press to report on malfeasances within government, access of the public to information (for example, via legislation on the freedom of access to information), and the application of sanctions in a fair way. Adherence to the law is enhanced when the highest political authorities demonstrate it by example. Conversely, if high level authorities are not sanctioned, the chances of corruption becoming widespread are significant.

Despite the plethora of laws and regulations, especially in francophone countries, there is little evidence in either francophone or anglophone countries that the legal framework for budget management is scrupulously respected. On the contrary, when high officials introduce new spending by decree or simply by ordering the treasury to pay for unbudgeted expenditures, the constitutional provisions or principles designed for preventing parliament to uphold budgetary rectitude are circumvented by government. In countries with such practices, corruption in budget management becomes widespread. Given the number of anti-corruption bodies that have been set up in recent years in both francophone and anglophone countries, it appears that budget and public financial management laws and regulations (among others) are not being fully respected.

2.4.3 Medium-term budgets: Country experience

Varying practices of MTBFs and MTEFs in advanced countries

The three fundamental objectives of a well-functioning budget system, including those supported by MTBFs and MTEFs, are as follows:

- Macroeconomic stability. The MTBF aims to demonstrate that budgetary policies are capable of achieving or maintaining fiscal stability and debt sustainability.
- Allocative efficiency between broad sectors of expenditure. If 'owned' by the cabinet of ministers, the MTEF can help prioritise spending of ministries' programmes.
- Expenditure efficiency of specific spending policies. If detailed costing exists, the MTEF could help identify inefficiencies and choices between competing programmes and sub-programmes.

More specifically, an MTBF provides a quantitative framework for a government's medium-term fiscal policy objectives, presenting budget aggregates consistent with fiscal targets. These should comply with fiscal rules, should any be in place. At a minimum, the MTBF should provide estimates of debt, the overall balance, the primary balance, revenue, and expenditure. Both revenue and spending could be broken down further, for example, into total expenditure into wage and non-wage current spending, capital spending.

Preparing an MTBF is a 'top-down' exercise undertaken by the finance ministry in conjunction with other government agencies with macroeconomic responsibilities. In contrast, MTEFs are largely 'bottom-up' exercises – MTEFs present multi-year expenditure estimates based on a costing of current and proposed policies or programmes/activities/projects. Spending ministries take responsibility for preparing detailed costings. The bottom-up MTEFs need to be consistent with total expenditure ceilings, as specified in the MTBF. In view of this, the preparation of MTEFs has to be closely co-ordinated with the MTBF: iterations of ministries' proposed spending programmes take place to ensure that aggregate spending of MTEFs is in line with the total expenditure constraint of the MTBF.

Although the principle of marrying top-down and bottom-up estimates is universal, the manner in which advanced countries do this varies. In particular, the role played by outer-year spending ceilings, the detail of forward estimates including spending commitments, the frequency of updating MTBFs/MTEFs and the responsibilities for their projections differ in European countries (Box 2.4.2).

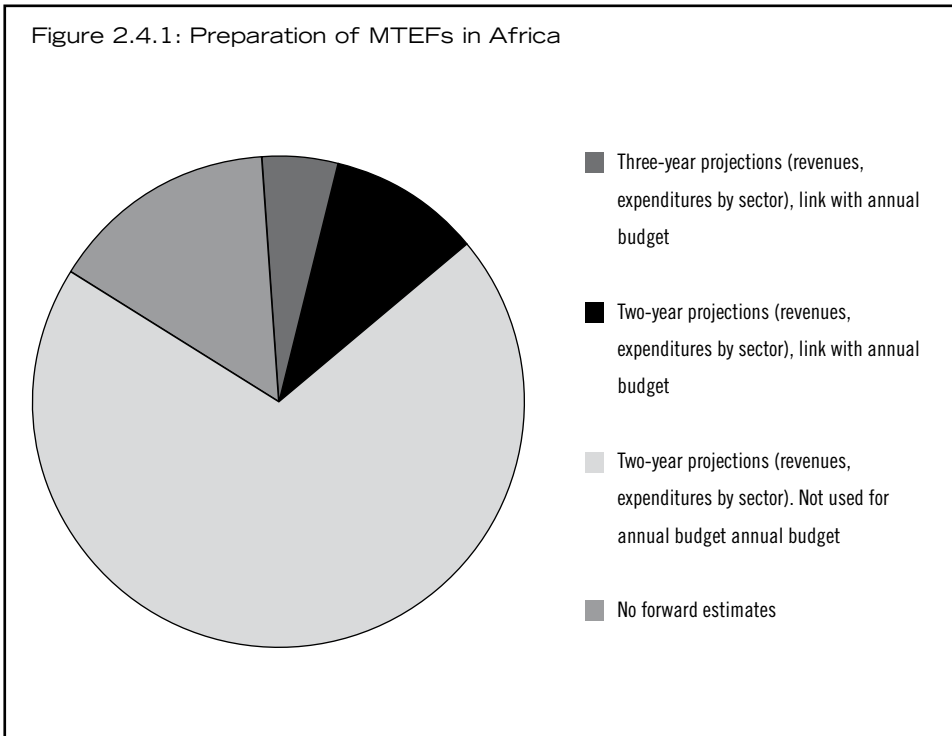
Do African countries prepare meaningful MTEFs?

Before discussing specific MTBF issues, it is of interest to know how many African countries prepare MTEFs and to learn how medium-term expenditure ceilings are used. Of the 24 countries reviewed by the Public Expenditure and Financial Accountability (PEFA) diagnostic tool during 2006–08,¹⁰ all but four of them prepare some form of MTBF/MTEF. Of the 20 countries with MTEFs, in only three cases are the medium-term expenditure ceilings linked with the annual budget expenditure estimates (Figure 2.4.1). This suggests that the MTEF exercise is largely mechanical, without any impact on the size of the annual budget or allocation between spending programmes. In summary, the MTEFs prepared in African countries have only a marginal influence on macroeconomic stability and allocative efficiency, and probably no influence on the efficiency of spending policies (detailed costing of spending policies is underdeveloped – see next section).

Box 2.4.2 Medium-term budget frameworks – selected European experience

There are considerable variations in the way European countries prepare and use MTBFs/MTEFs.

1. **Expenditure ceilings.** Firm multi-annual spending limits, or ceilings, need to be credible: with the government committed to complying with them. In some European countries, the spending ceilings are an internal tool used by government, and are not published or submitted to parliament for approval (for example, Denmark). In a few countries (for example, Sweden), rolling three-year expenditure ceilings are approved annually by parliament, with the aggregate ceiling binding for each year. Although the rolling annual budget is presented and approved according to 27 expenditure areas for a three-year period, government has full freedom to reallocate funds between these areas, provided that the overall ceiling approved by parliament is not exceeded.
2. **Detail of forward budget estimates.** The presentation of medium-term fiscal projections in budget documents varies substantially. In countries whose parliaments approve broad-based annual appropriations, the annual budget may contain an annex with information on the development of expenditure for each appropriation for two to three years beyond the budget year. However, in several European countries, detailed medium-term projections, if they exist (for example, Germany), remain internal. France's new programme-based budget is, for the present, strictly annual – there are no requirements for programme managers to prepared MTEFs.
3. **Fiscal forecasting.** To comply with expenditure ceilings, government must receive periodic updates of the MTBF/MTEFs. This requires adequate capacity to produce reliable projections of revenues and expenditures. The frequency of updates of MTEF projections varies considerably in European countries (for example, zero in France;¹¹ three per year in Denmark, and five to six per year in Sweden).
4. **Macroeconomic and fiscal forecasting independence.** Some European (and other OECD) countries rely on independent agencies to provide assurances of the integrity of macroeconomic forecasts. For example, the Netherlands Central Planning Bureau provides the forecasts of the relevant macroeconomic variables for the projections underlying government's budget bill.
5. **Multi-year commitments.** For investment spending (especially), government needs to enter into multi-year obligations. In some countries, parliamentary approval is required by law. Several European countries, such as Denmark, Finland, and Germany, include in annual budgets multi-annual commitments for some expenditures. In some cases, these are divided between commitments approved previously and new multi-year commitments.



2.4.4 Specific issues for medium-term budgeting in Africa

Are laws needed for medium-term budget management?

In francophone African countries, as illustrated in the case of Burkina Faso (see paper by H. Ouedraogo in this volume), present laws are based largely on a 1959 budget law from France. Although this legal framework stresses strongly the principle of annuality, WAEMU's directives do not require MTBF/MTEFs to be prepared. For francophone countries, this is viewed as a constraint. These countries are generally reluctant to undertake reforms that are not supported by an appropriate legal framework. In this context, one can query whether France's new 2001 organic budget law is a good model, given that this law does not require MTEFs – and France does not have an MTEF (Box 2.4.1, points 3 and 4).

The attitude towards law remains quite different in anglophone countries, where there continues to be an emphasis on flexibility on budget management, including choosing whether or not government should develop MTBFs/MTEFs. Although a number of anglophone countries have developed medium-term approaches to the

budget, this has in general been done without adopting a new law that requires it. In the case of Uganda, however, the Budget Act (2001) obliges the president to ‘lay before parliament estimates of revenue and expenditure for the next financial year’ and, for the medium-term, ‘the President *may* cause to be prepared estimates of revenue and expenditure covering three years’ (Article 3). Thus, the law requires a three-year MTBF, but not necessarily three-year MTEFs. Uganda appears to be the exception rather than the rule – most anglophone countries’ laws do not require preparation of MTEFs; yet many prepare them anyway. In the case of Kenya, parliament has recently attempted to fill what it perceives to be a legal void in budget preparation issues by preparing its own draft fiscal management bill. If adopted, the law would authorise the Kenyan parliament to prepare an ‘alternative budget’ to that proposed by government, a clear break with the inherited British system. (The UK parliament is prevented from doing this.) The draft law includes provisions for MTBF/MTEFs, which are included in the proposed ‘Budget Statement of Intent and Objectives’.

Medium-term fiscal stability and fiscal rules

In the interest of focusing attention on sustainable fiscal policies and medium-term stability, a few OECD and middle-income countries have adopted a fiscal responsibility act (for example, Australia, Brazil, Colombia, India, and New Zealand). These laws require government to present to parliament and the public its medium-term fiscal strategy and its budgetary policies aimed at achieving targets for key variables such as the fiscal balance and sustainable levels of debt. In Europe, member countries of the European Union (EU) are obliged to limit annual fiscal deficits to 3 percent of GDP and gross debt to 60 percent of GDP, as well as to achieve fiscal balance or a surplus over the economic cycle. Some EU countries have difficulty meeting these objectives. Also, EU sanction mechanisms are not fully effective.

In francophone African countries, the eight member countries of the WAEMU are subject to fiscal rules similar to those of the EU. In particular, WAEMU’s convergence, stability, growth and solidarity pact requires the fiscal balance for domestically-financed transactions and the level of public debt to be less than 70 percent of GDP. (The 1999 pact is available on <http://www.uemoa.int/actes/dec99/AA0499.htm>). The six countries of the Central African Economic and Monetary Union (CAEMU) have adopted similar objectives, although monitoring mechanisms are much weaker than in WAEMU (Avom & Gbetnkom 2003). As in the EU countries, the WAEMU Commission has difficulty in ensuring compliance with these ‘first order’ objectives (there are also a number of ‘second order’ fiscal rules).

Anglophone countries do not have comparable regional institutions such as the

WAEMU or the CAEMU. It is left up to each country to establish fiscal rules or decide to present medium-term fiscal policy objectives to parliament. Although few anglophone countries have adopted fiscal responsibility law (Nigeria is an exception), several anglophone African countries (for example, Tanzania and Uganda) have well-established mechanisms for discussing medium-term fiscal objectives, both within government and with the donor community.

Specificity of medium-term projections

In countries with detailed annual budget estimates, although it is technically possible to extrapolate each detailed line item of the annual budget for the subsequent two to three years, such mechanical exercises may have little value. In making strategic choices between competing alternatives, decision-makers at the highest level (cabinet of ministers, parliament) need only a few budget lines – perhaps 20–50. An annual budget specified by broad functions, sectors, or programmes is best for making budget allocation choices at a strategic policy level.

Annual budgets in African countries are prepared by ministries, departments, specialised bodies or agencies (MDAs), usually with a detailed economic classification that specifies the nature of spending. In the WAEMU countries, the directive on organic budget laws states that annual budget expenditures are divided between the six titles of recurrent and capital spending.¹² It also requires the annual budget to be adopted, for each MDA, by ‘chapter’, which is detailed in a WAEMU directive on budget nomenclature. This is a detailed economic classification, to be applied uniformly across all eight member countries. In the case of Mali, where a programme budget approach has also been developed, the programme budgets are attached as an annex to the annual budget law. As in the other WAEMU countries, the WAEMU legal framework prevents the adoption of a broad-banded set of budget appropriations. This restriction has severe consequences on MTEF development, the objective of which is to link medium-term budget projections to the preparation of the annual budget. When parliament must adopt an annual budget based on MDAs’ detailed economic categories of spending, it would not be meaningful to prepare MTEFs on this basis. In WAEMU countries, it will be difficult to achieve coherence between MTEFs, budget programmes, and annual budgets until WAEMU directives are changed (they are currently being reviewed). Currently, West African francophone countries are prevented from preparing programme-based MTEFs directly connected to the annual budget.

A similar problem exists in anglophone countries, even though there are not the same kind of legal constraints as there are in francophone countries. Budgets in some anglophone countries are extremely detailed (for example, Zambia). It would therefore

be meaningless to extrapolate such budgets over the medium term, as no decision-maker would use the detailed projections for Y+2 and Y+3. Again, a simplification of the estimates of spending presented to parliament is needed. This would not prevent retaining detailed spending projections for internal control purposes and for ministries' own budget management.

Programme budgets, new policies and MTEFs

A programme budget framework can facilitate strategic budget decision-making in a medium-term context. The programmes and sub-programmes or activities need to be coherent and any performance indicators need to be meaningful. Although some African countries have been experimenting with programme budgets, they are yet not used in high-level strategic decision making. Parliaments at best receive the programme budget as an annex to the traditional budget. This will continue unless African countries decide to break with input-based budget appropriations, largely inherited from colonial times. However, should any country decide to prepare its draft annual budget law, and accompany this with medium-term projections based on the same budget nomenclature, for example, by programmes or some other broad-banding of expenditures such as 'missions', 'outcomes', 'outputs', 'functions' or 'sectors', the preparation efforts for such an important change should not be underestimated. Careful reflection is needed to prepare for such a far-reaching reform.

Thus the adoption in Cameroon of a new organic budget law in December 2007, based mainly on France's 2001 organic budget law that introduced the programme-based annual budget, needs to be viewed circumspectly. The intention of implementing the new law in Cameroon for the 2009 annual budget discussion in 2008 is excessively optimistic. In France, it took five years of careful preparation by well-trained civil servants. Not only was a special budget reform directorate created in the finance ministry,¹³ but new programme managers in spending ministries were trained to take on new budget management responsibilities. Any country must adapt another country's law to its own circumstances. In this regard, Cameroon's 2007 law does not appear to take into account its provincial structures.

More fundamentally, the MTBF/MTEF approach is usually based on a clear distinction between the medium-term impact of existing (or ongoing) policies and new policies. In advanced countries, it is normal practice to prepare a set of 'baseline' forward spending estimates (MTEFs) based on a continuation of existing policies for the three- to five-year projection period. Given the baseline scenario for the MTBF (revenues, fiscal balance targets, and so on), the forward spending estimates indicate the 'fiscal space' for new spending policies.

In this context, the francophone African countries are left with this dilemma: Should they continue to look to France as a model to follow (which appears to be the case if the Cameroon example cited above is representative)? The dilemma revolves around the legal provisions regarding new versus existing policies in the new (2001) and old (1959) OBLs. First, neither law requires MTEFs to be prepared. Second, the 1959 ordinance required a single vote by parliament for all ongoing policies, but ministry-specific votes for each new policy. This provision is reproduced in Article 32 of WAEMU Directive No. 05/1997 relative to OBLs. However, in France's 2001 OBL this distinction was abolished.¹⁴ Thus, France today is deprived of both MTEFs (projections of each budget programme) and a focus on the medium-term fiscal space so that decisions regarding a continuation of existing policies may allow for new policies.

The choices to be made in the face of changes in the inherited legal framework is not an issue in anglophone African countries, where there is greater freedom to develop MTEFs, taking the best from international experience and adapting it when necessary. Nonetheless, both regions do not have complete choices on new medium-term fiscal policies – and hence their MTEFs – given the important role that donors play in 'assisting' African governments in making budgetary choices. This is particularly the case when it comes to investment and other 'development' expenditures.

Dual budgeting

The practice of dual budgeting – preparing one budget for recurrent expenditures and another budget for 'development' spending – has been widespread in Africa. When spending ministries are not fully responsible for preparing an integrated budget, the development of ministries' MTEFs is thwarted by dual budgeting. To integrate recurrent and development budgets, African countries are at varying stages in taking the following steps:

- Presentational and legislative integration. This is the first and easiest step in integrating the two budgets. Instead of two separate documents, a single document is prepared, showing for each spending ministry, expenditures for parliamentary approval in a consolidated annual budget law (or an appropriations act based on estimates of expenditure, ministry by ministry). Several African countries now do this, although donor-financed project spending may only be included in the annual budget law for presentational purposes, not for approval (since national governments and parliaments do not control the actual spending of donor-financed projects, and therefore cannot be held accountable for execution of these expenditures).

- Institutional integration. A second step towards integration is to merge central institutional responsibilities for preparing the integrated budget. In the past, it was prevalent for a separate planning ministry (or equivalent) to prepare the 'investment budget' (after reviewing the projects in the PIP), while the finance ministry prepared the 'recurrent budget', which often did not take into consideration the recurrent spending implications of investment projects. In order to facilitate the integration of the two budgets, a number of African countries have merged the ministry of planning with the ministry of finance (the most recent example is Tanzania – the two ministries were combined in 2008). In other countries, separate ministries still exist. In such cases, to prepare and execute a fully integrated budget, very close collaboration is needed between the two ministries. Unfortunately, this seldom occurs in practice.
- Managerial integration. A third step is to allow managers in spending ministries to prepare and execute an integrated budget. This is probably the most underdeveloped aspect of budget integration in African countries. In the case of the francophone countries, the high degree of centralisation of budget power in the finance ministry (see next sub-section) has discouraged the development of managerial capacity in spending ministries, at least relative to anglophone countries, where ministerial responsibility for budget management is part of the inherited British system.

In the francophone countries, it could also be argued that the distinction, in France's 1959 organic budget ordinance, between annual authorisation for cash spending and multi-annual authorisation of investment spending commitments encouraged the development of a dual budget system. In France, until recently, the national assembly approved multi-year appropriations for investment executed by the state (Title V) and transfers for investments approved by the state (Title VI). The annual cash spending limits for central government were shown for years +1, +2 and +3, plus any remaining years. This practice, which was never developed to the same extent in francophone African countries, focused attention on an 'investment budget', separate from the recurrent budget (Titles I to IV), for which only annual cash authorisations were approved by the national assembly.¹⁵ Also, in France's local governments, where there is considerable investment spending (for example, the construction of schools), the local government laws that regulate budget preparation explicitly require separate treatment of the recurrent and investment portions of budgets adopted by local councils.¹⁶ If the advisors in francophone Africa are familiar with these practices, it is possible that francophone African governments will be advised to distinguish strongly between recurrent and capital spending.

Although anglophone countries did not inherit any legal provisions relating to multi-annual appropriations for investment, the ‘development budget’ was often separate, as in francophone countries. Even if integration of the two budgets has taken place, at least partly, the ‘development’ or ‘investment’ portion of the budget continues to be financed largely by donors, which influence its composition. Concerning donor-financing, it is difficult for finance ministries to prepare meaningful MTBFs and MTEFS when donors either do not provide multi-year projections of disbursements (the problem of under-recording of grants/loans by some bilateral donors/creditors persists) or they provide tenuous multi-year projections, which are subject to changes in home capitals for political reasons and/or revised perceptions of performance and fiduciary arrangements in place in beneficiary African countries.

In summary, the development of binding expenditure ceilings – an integral part of MTEFs – is thwarted by: the persistence of some aspects of dual budgeting; and the non-comprehensiveness and lack of viable multi-year projections of donor disbursements for foreign-financed investments.

Capacity to prepare medium-term projections

The preparation of meaningful medium-term projections requires forecasting capacity to be developed at two levels:

- Within the finance ministry (or an equivalent central agency). Capacity is needed to prepare the ‘top-down’ aggregate estimates for expenditure, consistent with the medium-term macroeconomic and fiscal frameworks – the projections of all key macroeconomic aggregates and variables, especially medium-term projections for total revenues, grants, financing, and public debt objectives.
- Within spending ministries. Costing is a ‘bottom-up’ process, based especially on assumptions on volumes and unit costs of ministries’ programmes, activities, and projects. Developing capacity within spending ministries for costing programmes and projects is crucial for successful implementation of the MTEF approach.

Macro forecasting has developed in finance ministries in Africa, some of which have established a specific macro-fiscal department separate from the budget department. However, there is variable quality in capacity to project revenues, cost major expenditure policies, project macro-fiscal variables and conduct debt sustainability analyses. Apart from rigorous questioning by international organisations (notably IMF missions), there is generally no scrutiny of the projections by an outside agency,

nor are there independent agencies that provide inputs into the projections (c.f. Canada, where the government relies on private sector forecasts for the key economic assumptions for the budget).

Relative to the finance ministry, medium-term projection capacity in African MDAs is weaker. Not only do expenditures of the ministry have to be projected for periods of three years or more, but ministries' own revenues do as well. However, in a number of countries, ministries hide a portion of own revenues off-budget, thereby undermining the comprehensiveness of the MTEFs. In other instances, the medium-term spending projections coincide with what the ministry would like to receive year by year, but these amounts are unrelated to ceilings that the finance ministry establishes and disseminates, perhaps in the annual budget circular.

When medium-term projections are prepared, at a minimum, they should be endorsed by the cabinet of ministers and used by ministers for making strategic choices. However, this rarely happens in practice. For example, even in Mali – the only country according to the 24 PEFA reports that has a link between its three-year MTBF/MTEFs and the annual budget (see Figure 2.4.1) – the medium-term projections are not endorsed by the cabinet of ministers (although this is to change for preparing the annual budget for 2009, when the MTBF/MTEFs will be prepared for 2009–11).

Finally, medium-term projections should be updated at periodic intervals, to account for changes in macroeconomic assumptions or policy changes having budgetary impact. Such updating requires well-developed forecasting methods, tools and capacity. In many African countries, however, these are lacking. As a result, comprehensive updating of the MTBF/MTEFs may only be an annual exercise. When this happens, it is good practice to explain why the Y+2 projections of 12 months earlier differ from the new Y+1 projection. Typically, however, outer year projections change without explanation.

Centralisation of power for budget management

If an economic agent is obliged to complete a task, the capacity to do so develops: staff and materials will be mobilised, and tools developed to accomplish the task. Conversely, if an agent is not responsible for a given task, he/she has no incentive to develop capacity for that task. These principles are now examined in the context of budget management in centralised and decentralised environments.

The major difference between the inherited public finance management systems in francophone and anglophone Africa revolves around the degree of centralisation of budget and financial management in the finance ministry versus that of spending

ministries (Lienert 2003). In francophone countries, the finance ministry not only centralises the preparation of budget estimates, as is the case in anglophone countries, but it also approves every expenditure commitment and every payment order that is sent to the central treasury – also under the finance ministry – for payment by a public accountant (Bouley *et al.* 2002). Apart from initiating spending and ordering goods and services, once spending is approved by the finance ministry's financial controllers, the spending ministries are no longer involved. In francophone African countries, centralisation is even greater than in France, since the finance minister is the *ordonnateur unique* – the only person who can authorise spending to be paid, a task that is generally delegated to the budget department of the finance ministry, which approves payment orders and then sends them to the finance ministry's treasury department for payment and accounting. Ministries do not know if invoices have been paid or not – this is not their responsibility, only the finance ministry's. Within the course of the year, ministries are unable to monitor how actual payments for budgeted spending are developing. ('Budget execution reports' show a comparison between budget appropriations and spending orders sent to the centralised treasury, not payments by the treasury.)

In sharp contrast, the accounting officers, or more exactly, accountability officers, in anglophone countries, are highly-placed civil servants – generally the heads of spending agencies – who are responsible for all major aspects of budget and financial management, from budget preparation, through budget execution, internal control, payment (in some countries, but not all), and the keeping of accounts of payments versus budget allocations. In the inherited British system, accounting officers are also responsible before the public accounts committee of parliament, to defend budget outcomes and to follow up on recommendations made in the reports of the controller and auditor-general.

Clearly the anglophone countries have a head start for preparing MTEFs, since budget managers in spending ministries are already used to taking on several responsibilities for budget management. Thus, the preparation of medium-term projections is not so daunting for spending ministries, who already have a relatively higher degree of accountability and budget management experience than senior civil servants in francophone countries.

Role of parliament in the budget process and MTEFs

The paper on Burkina Faso and especially that on Kenya included in this volume indicate the increasing involvement of African parliaments in budget processes. This raises the question of what role parliament should play in MTBF/MTEFs.

As a first observation, the inherited budget systems from France and the United

Kingdom provide very little scope for parliament to change the government's proposed budget – both country groupings' parliaments have strong limitations on the power to amend *annual* budgets. In general, executive power in both regions is particularly strong by democratic country standards. In francophone countries, this stems largely from written constitutions, which are based on the 1958 French Constitution that provided the presidency with strong powers (in contrast to the relative weakness of the executive during post-second world war régimes in France during the 1950s). In anglophone countries, the strong presidency also comes from the strong constitutional position of the United Kingdom's head of government, who is not only usually the leader of the majority party in parliament (House of Commons) but also provides, when necessary, counsel to England's head of state that is virtually incontestable. In anglophone Africa, in adopting the Westminster system, the president is provided with very strong constitutional powers, usually as both head of state and head of government. These provisions result in a limited role of parliament.

In view of parliament's limited scope to amend *annual* budgets, and also the fact that parliamentarians throughout the world have short-term visions for budgetary and other policy changes effected by them as law-makers, it is questionable how meaningful it is to present MTEFs to African parliaments. Clearly the MTBF should be presented as background information, to inform parliament of the assumed future direction of budget revenues, expenditures, and targets for the fiscal balance and debt. However, if parliament has: (a) no authority to set spending ceilings for the years Y+2 and Y+3, let alone change allocations of outer-year spending; (b) is not provided with MTEFs consistent with the classification structure of the annual budget; and (c) is provided with annual reports or accounts on budget execution that show that actual outcomes were substantially different from the Y+1 projections approved by parliament, implying that the Y+2 and Y+3 projections are virtually devoid of meaning (and will be quietly forgotten by the finance ministry), then it is questionable whether the submission of MTEFs to parliament is worth the effort. As a starting point, to enhance the transparency of the government's proposed budget policies and to allow parliament – and the public – to understand the medium-term impact of any changes in budget policies included in the annual budget, it would appear sensible to require African governments to present to parliament the MTBFs. The decision to also provide to parliament sectoral or detailed MTEFs perhaps should be made by parliamentary committees: if the parliamentary budget committee (should it exist) find MTEFs useful as background information during the evaluation of annual budget proposals, then they could be transmitted to parliament. However, if a budget committee is not functioning, or parliamentary committees prefer to focus

exclusively on annual budget projections, MTEFs could be used as tools solely by the political and technical executive branch of government.

MTEFs and decentralisation of budget management

A number of African countries are enhancing the budget-making responsibilities of sub-national governments, usually by transferring some expenditure responsibilities to them and providing transfers from the central government's budget to finance devolved government activities. A key objective is to bring policies 'closer to the people' and to hold local government policy-makers accountable. As decentralisation efforts proceed, some governments – sometimes at the behest of donors – are requiring local governments to prepare MTBFs/MTEFs.

Given that no central government in Africa has an effective MTEF – one in which the Y+2 estimates affect the annual budget of the following year – the preparation of MTEFs at decentralised government level in Africa needs to be viewed with extreme caution. If central governments lack capacity for iterative projections of top-down and bottom-up spending, how much less likely will it be that local governments would have such skills?

2.4.5 Conclusions

This paper aimed at answering three questions, which are now addressed in turn:

Are African countries uniformly introducing medium-term budget systems?

Mainly due to pressures by donors to adopt MTEFs, many African countries have adopted some form of medium-term budget and expenditure framework. However, no country has an effective, operational and comprehensive MTEF. First, the Y+2 estimates made in Y+0 are not systematically used as the starting point in Y+1 for preparing the annual budget for Y+2. This is true even at the level of aggregate expenditures, not to mention sectoral or ministry-specific MTEFs. This is perhaps not surprising, given that a number of advanced countries, including France, do not have MTEFs that meet this criterion. In Africa, the challenge of developing MTBFs/MTEFs is even greater than in advanced countries, whose macroeconomic framework is more stable, a result of having more broad-based economies, less dependence on exports and imports whose prices fluctuate widely, and, in general, political and institutional stability.

Are legacy issues constraining the introduction of 'internationally acceptable' MTBFs and MTEFs?

In francophone countries, the role played by directives of the WAEMU Commission – inherited from laws and regulations adopted in France in 1959 and 1962 – is a

constraint to the introduction of MTBFs/MTEFs. Currently, any broad-banded medium-term expenditure projections are inconsistent with the estimates of annual budget laws. Most francophone countries have a regional obligation to abide by the directives on budget nomenclature for spending, detailed by its economic nature. Similarly, the high degree of centralisation, in the finance ministry, of budget policy, planning, preparation, execution and control – all part of the inherited French system – acts as a constraint on developing capacity in spending ministries for medium-term budget planning and projections. Despite this, in a few, such as Burkina Faso and Mali, spending ministries draw up MTEFs, including on a programme basis, which is proving useful for internal planning and prioritisation of policies within ministries. However, even in these countries, the finance ministry is unable to concede additional budget power to spending ministries, since the WAEMU directives maintain that only the finance minister – not spending ministers – have authority to approve spending of agreed budgetary policies. Spending approval is generally delegated to the budget department of the finance ministry, after ex ante controls are performed by financial controllers, also under the finance ministry's authority.

In contrast, in the anglophone countries, there is neither a strong tradition of needing a law to introduce budget reforms (Uganda, exceptionally, adopted a law in 2000 requiring rolling MTBFs), nor is there a strong concentration of power in the finance ministry. On the contrary, the British-based budget system has upheld the principle of accountability of the accounting officer – usually the permanent secretary (head civil servant) of each spending ministry – who is responsible for all major aspects of budgeting, including medium-term planning and budget projections, annual budget execution and spending. Accounting officers are accountable for budget management before a public accounts committee of parliament, whose members could, in principle, question budget managers on how they intend to reorient spending in order to achieve medium-term budgetary objectives. In practice, this seldom occurs, since parliaments in anglophone countries, although becoming an active voice in budget management, are focusing on short-term budget questions, particularly those that affect their constituencies, rather than being concerned about the plausibility and usefulness of the MTBFs/MTEFs that they may receive as part of the documentation for the annual budget. In francophone countries, to the extent that parliaments are becoming active, notably in countries where democracy has taken root, parliamentary budget committees (*commissions des finances*) are often not well equipped to provide critical analyses of government's proposed MTBF.

Are there other constraints, apart from legacy issues, that thwart the introduction of effective MTBFs?

The major non-legacy constraint is the capacity to prepare not only 'top-down' MTBFs, but also well-costed 'bottom-up' MTEF projections. Capacity is needed not only in the finance ministry but also in spending ministries. This is often the major constraint in Africa. In addition, the comprehensiveness of MTBFs is adversely affected by the non-availability of medium-term projections of donor aid or loan disbursements, which finance most of the public investment projects in Africa. These may not be budgetised at all – hence excluded from the MTBF. If budgetised, obtaining reliable outer year projections from donors is problematic. In these circumstances, African finance ministries are unable to prepare meaningful medium-term spending ceilings, ministry by ministry, inclusive of donor-financed spending. This thwarts ministries' ability to make medium-term plans where financing is assured with a reasonable degree of certainty.

Summary

In summary, many countries throughout Africa have made efforts to introduce a medium-term perspective to budgeting, but very few, if any, have reached a stage where MTBFs/MTEFs materially impact the revenues and expenditures (inclusive of donor-financed spending) of annual budgets adopted by parliaments. Legacy issues have an important bearing on the present inadequacy of MTBF/MTEF development in Africa. The francophone countries in particular, have legal constraints preventing them from making projections of expenditures at a high enough level of aggregation, for example, by broad-banded budget programmes, because regional directives on budget classification require the annual budget to be prepared on a traditional detailed economic classification. Moreover, these countries are reluctant to advance MTEF development until there is a legal requirement obliging them to. In contrast, anglophone countries have greater flexibility to decide whether to develop further their MTBFs/MTEFs, and to adapt them to country-specific circumstances. In summary, this essay supports the conclusions of other studies (for example, Oxford Policy Management 2000) that indicate that the preconditions for successful implantation of MTEFs in Africa are difficult to obtain. In these circumstances, the priority given to the development of MTEFs may need to diminish (Le Houreau & Taliercio 2002), and greater attention given to ensuring that annual budget processes are performing fully satisfactorily.

Endnotes

1. Ministry of Economics and of Finances, Ministry of Health, Ministry for Basic Teaching and the Elimination of illiteracy, Ministry for Higher Secondary Education and Scientific Research, Ministry of Defence and Ministry for Territorial Administration and Safety.
2. In Mali, however, parliament played a decisive part in the adoption of a programme budget. The documentation in fact now formally forms part of the appendices to the national budget submitted to the vote of the Assembly.
3. The 2003 and 2004 HIPC/AAP joint evaluation of the capacity to monitor poverty reduction expenses concluded that Burkina Faso has a sound system of public financial management on the basis of its performance against 16 indicators. The evaluation noted outstanding issues with regards to external financing, the classification of poverty expenses, the effectiveness of internal control, procurement and the timeliness of audited financial information to the National Assembly.
4. See Case Study on Kenya, 1st Annual CABRI Seminar Publication.
5. Source: UK Government Accounting Manual.
6. *Who Controls the Budget: The Legislature or the Executive?* Ian Lienert 2005.
7. Source: UK Government Accounting Manual.
8. The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy.
9. This is still the case in some countries ó even after revision of laws adopted in the 1960s, for example, Tanzaniaís Public Finance Act 2000, which replaced a 1961 ordinance (in turn based on the United Kingdomís 1866 Exchequer and Audit Act), and Uganda's Public Finance and Accountability Act, 2003. In contrast, the Public Financial Management and Accountability Bill that was presented to the Kenya parliament in December 2000 were split between a Public Audit Act 2003 and a Government Financial Management Act 2004. Similarly, in Malawi, in 2003, a Public Financial Management Act and an (external) Audit Act were adopted separately.
10. PEFA=Public Expenditure and Financial Accountability. The PEFA indicator PI-12 assesses countries multi-year fiscal forecasts and functional allocations. Figure 2.4.1 shows dimension (i) for the 24 countries that have had at least one PEFA assessment during 2006-08.
11. France does not project the central governmentís (stateís) budget programmes over a three-year period. It does, however, prepare, in the context of the EUís Growth and Stability Pact, more aggregate three-year projections for general government. These are also shown to the National Assembly twice a year. However, the annual budget is completely de-linked from the MTBFs (see Lienert, 2008).
12. For recurrent spending there are four titles: salaries, other goods and services, transfers, and debt servicing. Capital spending has two titles: investments executed by the state and capital transfers.

13. The finance ministry is being used generically. The author is aware that the previous ministry included economy and industry, and that ministerial structures were created after the election of President Sarkozy.
14. The distinction was however retained for the case when parliament does not adopt the annual budget law by 31 December. The OBL provides, as from January of the new fiscal year, that the previous year's budget would be implemented on the basis of one-twelfth of the existing policies (*services votés*).
15. This practice changed as from 2006, when a programme-based budget was introduced for all ministries. For all expenditures, the National Assembly approves annually, separate amounts for spending commitments (*engagements*) and for cash spending, for each of the 132 programmes of the main budget. Indicative levels of the economic type of cash spending (salaries, non-salary recurrent, investment, intervention) are shown in detailed tables. Spending commitments, however, can be carried over to the following year without limit (in effect, they are multi-annual), provided they do not increase salary spending in the following year.
16. See France's Local Authority Code, especially articles L1612 and L2331. These indicate that budgeted investment is financed by transfers from the recurrent section of the budget, own resources, and borrowing.

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3

Mobilising domestic revenues

3.1 Introduction

While a medium-term perspective in budgeting fosters policy constancy and therefore spending effectiveness, and strengthens macroeconomic stability, it often falters when inflows into the budget are highly volatile, in turn because of poor tax practice, macroeconomic instability or donor decisions. Many CABRI countries are familiar with the negative spiral, where either a short-term shock or a long-term structural problem causes a level of instability that hinders them from implementing medium-term perspectives required for the stabilisation of the policy environment for growth and development.

This chapter looks at how CABRI countries have managed themselves out of such situations. It covers two approaches to the stabilisation of revenue: tax policy and administration interventions, and a package of interventions across the public finance policy spectrum to improve fiscal outcomes. In relation to the first approach, Andrew Okello, Regional Advisor on Tax Policy and Administration at the IMF East-AFRITAC discusses a menu of tax interventions that have been used in the region to improve the magnitude and stability of countries' tax revenue streams. Patrick Ocaïlap, Uganda Budget Director, next explores how Uganda used a combination of tax policy and tax administration measures to overcome weak compliance and improve its tax-to-GDP ratio.

In relation to the second approach, Rwanda and Malawi share how they engineered a turnaround in fiscal outcomes. In the first paper by Malawi Budget Director Dorothy Banda, Banda discusses how a package of fiscal, budget and financial management reforms turned around the fiscal crisis of the early 2000s. The second paper by Rwanda ODI fellow Frances Cossar and Budget Director Elias Baingana, sets out the route Rwanda took as a post-conflict country to recover from pre-war economic decline and the shock of the genocide itself. The interventions included being deliberate about first stabilising revenue flows and expenditure demand before introducing a medium-term expenditure framework.

3.2. Revenue administration reforms: Developments in the East AFRITAC region¹

Andrew Okello

3.2.1 Introduction

The reform agendas of African countries are full of undertakings that require major funding on a sustainable basis, from national infrastructure projects to investment in education and health. An efficient tax system will provide the most sustainable source of government funding in the long term. Tax reform can stimulate business by reducing the burden of compliance and eliminating distorting effects in the economy, producing an upward spiral of growth in tax revenues. More effective compliance programmes can increase revenues without changing tax rates by bringing non-compliant taxpayers into the net. Tax reform can also address the income gap differential within developing countries to distribute wealth more fairly and equitably. Where the capacity of the state to collect taxes is weak, certain taxes may be preferred to others because they are relatively easier to collect. In these cases tax policy is determined by feasibility, rather than efficiency or equity. Increasing the

government's capacity for tax administration is therefore essential to enabling better tax policy as well as a pre-condition to implementing it successfully.

3.2.2 Revenue administration reform agenda

Governments in the region have prioritised and embarked on comprehensive reform programmes whose overall objective is to establish effective and efficient administrations. The programmes typically entail organisational redesign, including establishing revenue authorities and shifting from a tax and geographical focus to a combination of functional and taxpayer segment design elements. Other elements include implementing systems and procedures that are based on the principle of self-assessment and supported by risk-based controls. These reforms are typically implemented in the large taxpayers offices (LTO) as organisational stepping stones on the journey to complete organisational transformation. Many benefits are expected to accrue with the reforms, including:

- improved tax compliance
- more equitable distribution of the tax burden
- consistency and fairness for taxpayers
- reduced compliance costs and better services
- reduced tax evasion
- greater transparency and integrity.

3.2.3 The establishment of revenue authorities

The advent of the semi-autonomous revenue authority (RA) over the past two decades has been a distinguishing feature of revenue administration in anglophone Africa, perhaps more so than in any other country grouping. Leading the RA trend in the mid-1980s Ghana established separate revenue services for tax and customs administration that were loosely brought under the auspices of an RA governing board in 1998; this was followed by Nigeria's creation of separate revenue services for customs and tax administration in the early 1990s. However in 1991, Uganda established the first incarnation of the model that became more widely emulated over the next 15 years in Kenya, Tanzania, Rwanda and Malawi. This model brings all major central government revenue collection activities² under one organisational umbrella. It also broadly attempts to provide a degree of autonomy through a governance arrangement that is theoretically at a distance from the minister and ministry of finance unlike the more traditional government department.

There are, however, several factors that may limit this objective:

- The minister of finance usually retains influence and power in several key areas:
 - in making or recommending appointments to the board
 - through one or more senior ministry officials with ex-officio board membership
 - legislatively mandated ministerial powers to give broad direction to the board.
- Tax policy determination usually (and preferably) remains the preserve of the ministry, although importantly with inputs of an administrative nature from the RA.
- Like all spending institutions, an RA is dependent on adequate government funding from the finance ministry. Even the few RAs with statutory funding formulas instituted to protect their financial independence sometimes find these provisions overridden and subject to the more typical bidding for scarce budgetary resources.

3.2.4 Voluntary compliance and self-assessment

A key objective of a modern tax administration is to optimise tax collections while minimising administration costs and taxpayer compliance costs. The most cost-effective systems of collecting taxes are those that induce the vast majority of taxpayers to meet their tax obligations voluntarily, leaving tax officials to concentrate their efforts on those taxpayers who do not comply. Experience shows that voluntary compliance is best achieved through a system of self-assessment. Under systems of self-assessment, taxpayers calculate their own tax liabilities and submit tax returns, which are accepted as filed – subject to a few simple checks by the tax administration to ensure that the taxpayer has completed the appropriate items on the return form. Subsequent to filing, the tax administration is permitted by law to amend returns and apply penalties if it is discovered that a taxpayer has evaded tax. The self-assessment approach accepts the reality that no tax administration has sufficient resources to determine the liability of every taxpayer. It also recognises that taxpayers themselves – with appropriate assistance from the tax administration – are in the best position to determine their tax liabilities.

The adoption of self-assessment practices in the region has been closely linked to the rise of VAT, reflecting the predominant view that VAT is feasible only as a self-assessed tax. The experience of most countries that have implemented a VAT has been to subsequently extend self-assessment to the administration of income taxes.

However, as the self-assessment system in most countries is inadequate, there is the need to give careful consideration to the conditions necessary for an effective self-assessment system. These include the development of:

- an appropriate legal framework, with clear and simple laws
- taxpayer education and assistance programmes
- simple registration, filing, and payment procedures
- effective collection and filing enforcement
- an audit programme applying risk-management principles and methodologies
- appropriate use of penalties
- a fair and efficient appeals system
- IT support.

3.2.5 Tax administration reforms and developments

The organisational evolution of tax administration has been widely and well documented. It has seen a shift from an historical tax type approach, to a functional model across various taxes before recently transcending to a client or taxpayer segment solution.

By tax type

Historically, separate departments or divisions often existed for indirect taxes (sales tax or VAT) and direct taxes (personal and corporate income tax), sometimes even further sub-divided with units for excise taxes, and for withheld, personal, or corporate income taxes. Administration of each tax or sub-tax often occurred in isolation and without co-ordination or sharing of resources or information.

By function

Tax administration functions are universal, although they are sometimes described differently or grouped or sub-divided in various permutations. Beyond the degree of modernisation achieved, the emphasis and resources directed to certain functions is usually a product of whether an administrative or self-assessment system exists, or some variant between. A non-exhaustive list of functions includes registration, returns and payments processing, accounting, taxpayer services and education, compliance enforcement including collection, taxpayer audit and investigations, and dispute resolution (appeals). Under the traditional tax type approach, these functions (to the extent they exist) would be duplicated and unco-ordinated, increasing the costs of administration and compliance and failing to provide a single view and management of the taxpayer.

By segment

More recently, there has been greater recognition that customers (i.e. taxpayers) are not homogeneous. This has led to client segmentation approaches, such as private banking and business/first class travel. Segmentation recognises varying needs across taxpayer groups in terms of revenue importance and risks, degree of sophistication and record-keeping capability, and demand for services and assistance. Taxpayer size in terms of turnover has become the most common and best developed method for categorising and segmenting taxpayers.

3.2.6 Integration of domestic tax administration

Over the last 15 years, there have been major tax administration reforms within countries in the region, such as Kenya, Rwanda, Tanzania, and Uganda. A key feature of the reforms has been the integration of domestic tax administration. No two countries have approached integration in exactly the same way. However, the integration process in the region has the following common elements:

- a single head for the new tax department
- the legal framework for integration
- the new integrated, function-based organisational structure
- creation of a strong headquarters function
- field office configuration
- business process review
- human resources considerations
- information technology
- communications.

Important lessons from the regional experience

First, the integrated tax department should have a function-based organisational structure with a strong headquarters and field offices administering the various segments of the taxpayer population (large, medium, and small). Appropriate resources must be assigned to the head office of the tax department to monitor field office operations. For each function, a corresponding headquarters unit should be responsible for:

- strategic and operational planning on a national level
- the development of national programmes
- the provision of technical advice and guidance to operational field units
- the establishment of performance targets and measurement systems
- the monitoring and evaluation of field operations.

Headquarters units should not be involved in operations, which must be performed in the field offices (including the LTO).

Second, if integration is to be the platform for tax administration modernisation, a comprehensive review of all business processes as integration occurs will be key to improved effectiveness and efficiency, and improved services to taxpayers. Business process re-engineering (BPR) is not a casual initiative; rather, it is a formal discipline with rigorous and well-proven methodologies. Most organisations require outside expertise to implement BPR, to train managers and staff in its application, and to ensure efforts are comprehensive and consistent. BPR examines all sectors of the tax administration. For each function, teams are established to determine business requirements based on the laws being administered and other factors. Management decides the nature of the integrated business to be performed and how the related operational processes should be executed. Changes and improvements are then developed in the way the business is currently being carried out. These reviews must be led by the heads of the key functions in the new, integrated tax administration.

Third, an effective management of the human resources aspects of merging two departments and reorganising the tax offices will be key to the successful implementation of the new tax department. Some critical decisions need to be made up front. For example, if retrenchment (staff reductions) is not an objective, assurances can be given to staff about job security. However, even in this case, employees will have to realise that their work will be changing and that significant re-training will be needed in the future for many of them.

Fourth, an integrated tax administration system (ITAS) should eventually be the backbone of the new tax department. The business requirements for the ITAS can only be finally determined as and when business processes are reviewed and in the context of the policy and legislative framework that is designed to provide for taxpayer segmentation.

3.2.7 Taxpayer segmentation

Recognising the different risks posed by taxpayers, many tax administrations have developed organisational structures and compliance strategies on the basis of the three taxpayer segments:

1. A small number of larger taxpayers contributing bulk of the revenue (see Table 3.2.1).
2. A moderate number of medium taxpayers who are above the registration threshold for VAT (if set appropriately).

3. A large number of small taxpayers who contribute relatively little to overall revenue collections. Organisationally, this has been done through the creation of special offices for large, medium, and small taxpayers.

Administration of large taxpayers

Large taxpayers share common characteristics – they receive professional advice in accounting and taxation, maintain books of account that are subject to audit, but regard tax as a cost to be minimised through local and international arrangements and favourable interpretation of the law. Delays in detecting non-compliance of large taxpayers can place tax revenues at significant risk. Many countries have established a LTO within the tax department to secure tax revenues and provide appropriate services to large taxpayers. Countries often use the LTO as a vehicle for introducing tax administration reforms. A LTO provides a controlled environment in which new systems, structures, and procedures can be introduced, tested, and improved before they are deployed to the wider organisation and applied to a much larger number of taxpayers.

Table 3.2.1 Revenue contribution of large taxpayers in the AFRITAC East region

	Number of large taxpayers	Percent of total taxpayer population	Percent of revenue contribution	Number of staff
Kenya	812	1.3	72	147
Tanzania	370	2.0	70	80
Uganda	474	3.3	65	58
Rwanda	286	1.7	75	64

The first LTOs were implemented in the region around 1998 but none fully met initial expectations and in some cases were disbanded. Important lessons from early initiatives suggest that the role and place of the LTO must be clearly articulated within a broader modernisation strategy that entails a single, fully integrated tax administration, with additional reform phases addressing all taxpayer segments to avoid the perception that the large taxpayer ‘cash cow’ is being exclusively milked to exhaustion. More recently established or reinvigorated LTOs are considerably more effective, capacity has been enhanced, industry specialisation is being developed (such as mining), and IT systems are improving.

Administration of medium and small taxpayers

The extent to which clearly discernable differences exist in the treatment of medium and small taxpayers depends upon what type of regime exists, if any, for small

businesses. VAT is mandatory for those above the registration threshold, although many businesses below the threshold often opt in. Income tax regimes often apply universally, particularly for corporations regardless of size or turnover. Some countries, however, have simplified regimes for small businesses, often limited to unincorporated entities, and typically those outside the VAT regime. Specific regimes exist in Rwanda, Tanzania, and Uganda, usually as a simple turnover tax, or presumptively determined for a few industries like transportation. All the tax administration field offices in the region administer a mix of medium and small taxpayers, and also large in the absence of an LTO. While a few are considering the concept, none have yet moved to create a medium taxpayer office to emulate the LTO model.

3.2.8 Overview of customs reforms in the region

The revised Kyoto Convention proposes that countries should reform existing customs practices to further facilitate the movement of goods. A further proposal is that customs administrations should adopt modern BPR (transformation) techniques to identify inefficient or redundant activities for streamlining or elimination. Risk management approaches are strongly advocated as are special customs clearance schemes for the most compliant traders. The use of post-clearance audit controls and information technology (IT) tools are strongly recommended. A few of the countries in the region have conducted customs time release studies (TRS) with the assistance of the World Customs Organization (WCO): Kenya (2004 and 2007); Malawi (2005); Rwanda (2007); and Tanzania (2005). The results indicate less than optimal outcomes. The World Bank Doing Business 2007 report ranked countries on many issues including trading across borders. The general observations on trading across borders are that most countries were rated worse in 2007 compared to 2006. In pursuit of the trade facilitation objective, countries in the region have undertaken a number of initiatives to accelerate trade facilitation.

A number of countries tried to address revenue and corruption concerns by engaging pre-shipment/destination inspection (P/DIS) companies in the mid-1990s. The P/DIS companies particularly addressed the issues of valuation, classification and origin, and in some instances at the behest of the central banks, capital flight. Some utilised and then discontinued these services – Kenya (2005), Malawi (2007) and Uganda (2002). Key issues in discarding the services were complaints from traders that they were paying an unnecessary cost (usually about 1 percent of the cost, insurance and freight (CIF) value above a designated import value threshold). Additionally, the skills of customs officers in the functions of valuation, classification and origin determination were being lost. Tanzania is still using these services. There is no overwhelming evidence to suggest that the bottom-

line (customs revenue) improved dramatically following the use of P/DIS. It is also worth noting that the P/DIS companies are transforming their operations as the rising concern of core customs officer skills depletion mounts. Tanzania still has a P/DIS contract running out in 2011, and is refocusing on skills acquisition, especially for management of the risk management system of the DIS company.

Risk management and post-clearance audit activities are not well established in the region. The business intelligence and analytical skills are still very weak and will take some time to develop. A number of customs staff in these countries have been exposed to the principles of risk management and intelligence but the challenge is implementation, that is, placing the function appropriately in the customs administration structure and getting qualified staff to carry out the function. A start has been made in some countries with the assistance of IMF technical assistance – for example, in Kenya, Tanzania and Uganda – to establish the function, but it is early days yet. An important issue in risk management is the knowledge of trade patterns and operators. Segmentation in customs administration is just starting as part of risk management but no full analyses have been carried out in the customs administrations. The authorised economic operators scheme that is meant to provide automatic green channel privileges to tax compliant importers is yet to take root. Only Tanzania has, from June 2007, implemented the scheme but it is still too early to assess effectiveness.

All the countries in the region have automated their customs processes to varying degrees. However, from the available information, the automated systems have been primarily used for transactions processing rather than decision support. In a number of countries, less than satisfactory analytical use is made of the customs data generated by the systems for decision-making purposes, especially in enhancing risk management approaches. Some of the applications are still wanting with regard to their data-mining capabilities, but nevertheless, even the capacity that is available has not been sufficiently used.

3.2.9. Conclusion

Changing organisational design is important but not enough. A comprehensive revenue administration reform programme should include a review and improvement of business processes, adoption of risk-based programmes that reward compliance, and use of appropriate IT systems. Countries in the region have made a good start, but there is still a long way to go to enhance the efficiency and effectiveness of revenue administration. Priority areas include designing compliance management programmes for management of the medium and small taxpayer segments and natural resource taxation issues.

3.3 Uganda: The impact of tax reform on compliance

Patrick Ocaillap

3.3.1 Introduction

Uganda is a landlocked country located in East Africa with a population of about 30 million people. Its economy is largely agricultural and about 80 percent of the agricultural sector is monetised. The informal sector makes up a large portion of the economy and there are many small-scale operations. Many of these small-scale businessmen and women move around a lot and are therefore hard to tax. Also, they do not systematically maintain their accounts.

Tax takes in Uganda are affected by its long-term economic history. The long period of economic mismanagement in the 1970s and 1980s, when taxation was highly predatory, created a culture of tax avoidance and evasion (Gauthier & Reinikka, 2001).³ This affects the system to this day. By the mid-1980s, tax revenues had fallen to a low of 5 percent of GDP. In an effort to rebuild government's revenue base, a first reform was the establishment of the independent Uganda Revenue Authority (URA) in 1991. This was followed by tax policy reforms in the mid-1990s and further efforts

to improve tax administration over the subsequent decade. This paper examines these reforms, their effectiveness and the remaining challenges.

The tax to GDP ratio in Uganda is still low compared to other countries in sub-Saharan Africa (SSA). Currently, tax revenue to GDP stands at about 13.1 percent, which is far below the region's average of about 21 percent and the average for the Organization for Economic Co-operation and Development (OECD) of 32 percent. The budget speech in 1998 mentioned that the ratio in Uganda was 11.3 percent, compared to 18 percent in Kenya, 14 percent in Tanzania, 19 percent in Ghana, 17 percent in Malawi, and 20 percent in Mozambique and Zambia. These comparisons make it clear that there is both need and scope for considerable improvement in Uganda's revenue performance. Non-tax revenues also continue to lag the other countries in the region, at around 1 percent of GDP compared to the region's average of about 3.5 percent.

3.3.2 Tax policy reforms

Need to improve tax to GDP ratio

Increasing the tax to GDP ratio remains an important policy goal for Uganda, as it is an important way of reducing dependence on aid and increasing medium-term stability, which would underpin more strategic budget planning and management. To achieve this policy goal, government has introduced a number of tax reforms over the last decade. The reforms have been aimed at simplifying the tax system and reducing exemptions, reducing rates to increase compliance and improving tax administration to broaden the tax base. Significant specific reforms have included the introduction of VAT, a new tax act and more streamlined customs duties.

Introduction of VAT

The introduction of VAT widened the domestic tax base through this elastic, efficient, and neutral tax. Before 1996/97 the Ugandan government used to collect sales tax on imports and local goods (excise goods and other goods) and imposed a commercial transactional levy (CTL) on services. These taxes were enforced under the Sales Tax Act of 1970 and the Finance Decree of 1972. However, separately and jointly they constituted a very complex system. For example, under the sales tax the rates varied from 0 to 30 percent, and remissions were given to manufacturers and those who were registered for sales tax purposes for major business inputs (like capital goods and raw materials). The CTL rate was a uniform 15 percent. The system also led to tax cascading, as the tax paid under both arrangements on business inputs was not allowed as credit against the tax due. This meant that sales tax and CTL were applied to a tax-inclusive input cost. This does not happen under VAT because while credit

is allowed for VAT paid on all business inputs, the credit can only be claimed if the VAT levied by the enterprise is paid over. This makes the system more attractive for tax compliance. A further disadvantage of the sales tax and CTL regime was that government did not have access to a paper trail.

All this changed with the introduction of VAT, in July 1996. VAT was to replace both the sales tax and CTL. The tax base was widened substantially as all supply of goods and services was brought into the tax net, and there was a significant increase in the number of enterprises liable for the tax.

Simplified tariff structure

From 1996 onwards, tariffs were progressively liberalised to minimise tax distortions and promote tax compliance among tax payers. Before the formation of the East African Customs Union in 2005, which included Uganda, Kenya and Tanzania, tariff reforms in Uganda consisted of gradually reducing tariff barriers by lowering and simplifying the tariff structure and phasing out exemptions and import bans. The tariff structure was adjusted by decreasing the number and range of rates and the maximum rates. Initially, the rates applicable were of three bands of 0 percent for raw materials, 7 percent for semi-raw materials and 15 percent for final goods. With the introduction of the East African Customs Union the rates for the three bands were changed to 0 percent, 10 percent and 25 percent, for each of the respective categories.

New income tax legislation

The new Income Tax Act was passed in 1997 to streamline exemptions and improve incentives. The act removed the finance minister's powers to grant discretionary exemptions. It provided a new incentive regime for business development, which included establishing accelerated and streamlined depreciation allowances to give significant benefits for investments in new productive assets like plant, machinery and equipment. It also introduced presumptive taxation for small businesses (with turnover of less than UGX 50 million per annum), among others. Since then, revenue from income tax collection has increased substantially.

The list of excisable goods was lengthened to improve revenue takes. Before the tax reforms, there was a high dependence on a narrow range of excise duties on goods such as fuels, cigarettes, beer and soda. This has changed and tax rates have been stabilised. For instance, new tax handles have been introduced, like excise duties on mobile and land pay phones.

Tax appeal tribunal established

Finally, government introduced a tax appeals tribunal (TAT) as an independent mechanism to which all aggrieved taxpayers can go for redress. A number of complaints have been resolved and this has increased tax compliance.

3.3.3 Tax administration

While making these key reforms to tax policy, government also undertook to transform tax administration. Before 1997, tax administration was a direct function of the finance ministry, and carried out under three departments, namely customs and excise, inland revenue and income tax. These departments were organised along the traditional functions of assessment, collection and enforcement, and managed within the culture of the civil service. So an important initial step was the creation of a single arm's length tax authority. The Uganda Revenue Authority (URA) was thus created in 1991 to be solely responsible for tax administration. The authority was given the freedom to pay competitive salaries, hire and fire on the basis of performance, assess taxes, and control smuggling, among others. In short, it was set up as a single, semi-autonomous agency outside of the civil service, integrating tax administration across different taxes and with the capacity to attract more qualified staff with higher pay packages.

However, the mere creation of a single authority was not enough to bring large improvements in tax administration effectiveness. The URA largely inherited the problems inherent in the three source departments, and itself developed a culture characterised by dishonesty and a lack of commitment to administering tax collection in the public interest. At the same time it lacked the necessary specialised skills, had a hierarchical structure and autocratic management style, low staff morale coupled with high staff turnover and conflicting organisational goals.

Over the last decade, the URA has implemented further significant reforms aimed at improving administrative efficiency and increasing compliance levels. A number of systems have been developed to curb tax evasion, reduce revenue leakage and simplify and incentivise compliance. For example:

- The URA's relationship with taxpayers has greatly improved as it has been improving its corporate image.
- The URA has introduced customer care and taxpayer service functions in which taxpayers' needs, queries and concerns are promptly addressed.
- Improved taxpayer services have been introduced through direct banking.
- Taxpayers' complaints are dealt with more efficiently.

- Tax identification numbers have been introduced to reduce the time taxpayers spent fulfilling their tax obligations.
- IT-supported revenue management has been implemented, mainly for monitoring and control.
- Corporate taxpayers can do their own assessments of their taxable income, determine their own liability, file returns and pay accordingly.
- Taxpayers who have regularly complied with the income tax requirements, as well as importing for industrial production, are exempted from withholding tax.
- Permanent forums have been established for consultation with different categories of taxpayers. A number of women's organisations are represented on these forums.

Overall, the aim of these measures is to improve taxpayers' confidence in the URA and business ethics in general, thus increasing the level of compliance among taxpayers, as well as the integrity in tax administration. The URA has in fact become a hub of sharing experiences in modern tax revenue management within the region.

3.3.4 Tax revenue performance

It is important to note that most reforms were undertaken in the mid-1990s. Improvements in the tax revenue to GDP ratio started to become evident, as Table 3.3.1 shows. Between 1995/96 and 2006/07, the ratio increased from 10.4 percent to 13.1 percent. This implies an increase of 2.7 percentage points over 11 years. While this is not dramatic, it is encouraging that the gradual increase was systematic, suggesting a steady improvement. Nominal GDP has also shown a positive trend over the years, which also meant that government's performance in revenue collection increased in terms of domestic revenue available.

At the same time, the way tax revenue is structured has changed. Current tax revenue is drawn from a number of sources: direct and indirect domestic taxes, and international taxes. The tax base has thus shifted from an over-reliance on international trade taxes – with their distorting effect on economic growth – to a more balanced share of domestic and international taxes. Domestic taxes include both direct and indirect taxes. Direct taxes are personal income tax, corporate taxes, licence fees, withholding taxes, rental income, and presumptive taxes. Indirect taxes comprise excise duty on goods and VAT on goods and services. Table 3.3.2 shows the domestic and international tax structure between 1996/97 and 2004/05.

Table 3.3.1 Government recurrent revenue collection:
1985/86 – 2007/08

Number	Fiscal year	GDP market price (UGX bn)	Actual revenue collection (UGX bn)	Revenue: GDP ratio (%)
1	1985/1986	17.34	2.84	16.4
2	1986/1987	41.54	5.00	12.0
3	1987/ 1988	118.42	22.26	18.8
4	1988/1989	373.42	51.63	13.8
5	1989/1990	860.21	91.85	10.7
6	1990/1991	1758.59	133.78	7.6
7	1991/1992	2640.47	178.86	8.6
8	1992/1993	3730.29	283.77	7.6
9	1993/1994	4240.58	362.25	8.5
10	1994/1995	5211.92	502.61	9.6
11	1995/1996	5978.30	622.16	10.4
12	1996/1997	6499.09	729.70	11.2
13	1997/1998	7576.31	799.10	10.5
14	1998/1999	8202.74	948.90	11.6
15	1999/2000	8955.21	1010.30	11.3
16	2000/2001	9977.65	1083.50	10.9
17	2001/2002	10261.05	1246.80	12.2
18	2002/2003	11780.35	1409.00	12.0
19	2003/2004	13200.34	1642.00	12.4
20	2004/2005	15134.30	1887.30	12.5
21	2005/2006	17372.42	2231.09	12.8
22	2006/2007	20009.00	2625.80	13.1
23	2007/2008	22226.00	3076.10	13.8

Table 3.3.2: Structure of domestic and international trade taxes:
1996/97 – 2004/05

Financial year	Domestic	International trade
	Taxes %	Taxes %
1996/97	38.0	62.0
1997/98	42.1	57.9
1998/99	42.8	57.2
1999/00	43.9	56.1
2000/01	44.3	55.7
2001/02	48.9	51.1
2002/03	49.4	50.6
2003/04	48.5	51.5
2004/05	51.0	49.0

Source: Uganda Revenue Authority

As the figures in Table 3.3.2 illustrate, the income tax and VAT reforms undertaken by the Ugandan government in the 1990s led to increased domestic taxes, from a contribution of 38 percent in 1996/97 to 51 percent in 2004/05. This steady increase is matched with a decrease in the contribution of international trade taxes. This is a healthy position as it reduces government's over-reliance on trade taxes. The strong domestic tax performance is explained by improvements in tax administration, specifically the integration of domestic taxes and the strong growth of the service sector, particularly in the telecommunications and banking sectors. PAYE, company tax and withholding tax collections are reported to be strong and keep direct taxes above what was expected. On the other hand, the contribution of indirect taxes has stagnated, due to the poor performance of excise duties on local goods and the slower growth of VAT.

Table 3.3.3: Structure of domestic taxes:
1989/99 – 2006/07

	1989/99	2006/07
Direct domestic taxes	19%	61%
of which:		
PAYE	2%	31%
Corporate tax	17%	16%
Withholding tax	0%	10%
Other	0%	4%
Indirect domestic taxes	71%	50%
of which:		
Excise duty:	19%	16%
Value added tax:	52%	35%
Fees and licenses	0%	0%
Other	6%	0%

Source: Uganda Revenue Authority

3.3.5 Tax function responsibilities

Tax policy involves choosing tax instruments, the rates at which taxes are set, the nature of exemptions and how taxes are assigned across different sectors, while tax administration aims at the efficient and effective implementation of tax policy. The administration function involves the management of the collection and accountability of tax revenue in accordance with the taxation laws. Tax policy is a function of the Ministry of Finance, Planning and Economic Development, while tax administration

is a function of the URA. The URA administers taxes on behalf of government, within a framework of tax laws and statutes.

All taxes are imposed by an act of parliament in accordance with the Constitution of Uganda – Article 152. Relevant legislation includes:

- Local Governments Act (1997) (for local government revenues)
- Income Tax Act Cap 340 (for Income Tax)
- East African Community Customs Management Act (2005) (for managing import duties)
- Value Added Tax Act (Cap 349) (for imposing and enforcing VAT)
- Stamp Duty Act (Cap 342) (for imposing duties on various commercial and legal papers)
- Excise Management Act 1970 (for collecting excise duties)
- Traffic and Road Safety Act 1998 (Cap 361) (for motor vehicle licences and fees).

The process of drafting tax policy involves consultation with various stakeholders. Government meets regularly with the private sector in various forums where tax matters are discussed at length. Stakeholders, which include the business community, manufacturers, traders, donor organisations, development partners and private individuals, are given the opportunity to present proposals for government to review.

3.3.6 Challenges

Uganda's tax structure has greatly improved. Nevertheless, there are still challenges. Chief among these is the low tax to GDP ratio, which points to the generally low levels of tax compliance. A culture of tax evasion and avoidance is still prevalent in Uganda, which increases tax administration costs and lowers tax revenue. A shortcoming of the tax reform initiative in Uganda is that it did not include enough effective public awareness campaigns to remind citizens and businesses of their obligations and to raise their awareness about the link between public service delivery and tax compliance. There definitely seems to be a connection between the citizenry's perception of whether service delivery is good or bad, and the willingness to pay tax. The issue of tax compliance therefore cannot be addressed through the tax system alone, as it also relates to the ability of the public service institutions to demonstrate value for money. On the tax side though, ongoing measures to improve the collection of domestic revenue include continued consultation with tax payer bodies, improvements in the transparency of tax administration and refinements of tax policy.

3.3.7 Conclusion

Uganda's tax structure has greatly improved and it now largely mirrors the tax system in other SSA countries. The most important priority is to administer it equitably and efficiently. Current government policy involves ensuring a stable tax system without interfering with the rates, which forms part of a macroeconomic environment that is conducive to growth. All stakeholders are therefore encouraged to support government efforts in ensuring compliance and fostering economic development.

3.4 Malawi: The cost of short-term policy-making

Dorothy Banda

3.4.1 Introduction

The paper will discuss how medium-term fiscal policy issues can be informed by looking at the impact of current policies and practices on the economy. In particular, it will highlight some of the causes and effects of different fiscal policies in the economy of Malawi.

Malawi is a landlocked country in southeastern Africa, covering a total area of 94,300 km.² Over 50 percent of its population live in rural areas and are dependent on rain-fed agriculture for subsistence living. The country is divided into three administrative regions: the South, the Centre, and the North.

Malawi has experienced the effects of poor policy decisions and practices that resulted in poor economic performance, but saw an economic turnaround following a change in policies and practices. This paper looks at these policies and practices, and at their results.

3.4.2 Policies/measures and their effects during the period of economic decline (2002/03 to 2003/04)

Between 2002/03 and 2003/04, Malawi experienced an economic decline, as the economic indicators in Table 3.4.1 show. A number of inter-related and mutually reinforcing macro-fiscal and budget management factors over this period caused the deteriorating macroeconomic environment. Government started running into severe fiscal trouble when a number of factors led to it taking ill-considered and short-term emergency measures, which, in turn, worsened the fiscal position when their macroeconomic effects started to take hold. These included bailing out troubled parastatals, drought and maize shortages, poorly managed privatisation processes and reinvestment of the proceeds, and generally poor budget discipline. This resulted in the withdrawal of development partner and international financial institution support and an over-reliance on emergency domestic borrowing, which in turn had its own impact on the macro-economy, and budget and debt balances. The indicators below show the combined effect of some of these factors, such as rising debt, a declining currency, high interest rates and the withdrawal of financial support.

Table 3.4.1: 2002/03 – 2003/04: A period of deteriorating economic indicators

Economic indicator	2002/03	2003/04
GDP growth (real)	-3.0%	4.5%
Domestic interest as % of budget	14.5%	21.4%
Domestic savings/GDP	-12.6%	-10.7%
Net foreign assets	-5.3%	8.6%
Inflation rate	14.7%	9.6%
USD exchange rate	89.9	108.6
Domestic debt/GDP	20.4%	25.1%
Treasury bill interest rate (average)	38.3%	36.3%
Overall balance (including grants) as % of GDP	-8.5%	-5.6%
Domestic financing as % of GDP	8.5%	5.6%
Variation between budgeted balance of payments (BOP) support and amounts actually received as a % of budget	17.51%	8.05%
Budgeted BOP support as % of budget	19.91%	19.16%
Actual BOP support received as % of budget	2.46%	11.11%

The case of this short-term emergency decision-making in Malawi over this period points to the value of a medium-term outlook in fiscal decision-making as much as the years that followed, when government started to actively focus on medium-term fiscal policy and its impacts. A brief discussion of each of the factors follows.

Unrealistic measures for revenue collection

In the years before 2004/05, proposed revenue collection measures were unrealistic, which led to the private sector losing confidence in government. The large gap between revenue projections and actual collections undermined public and donor confidence. In addition, as the fiscal crisis started to take hold, domestic revenue measures were implemented solely to raise revenue in the short term, with scant attention being paid to their medium-term effects on growth and therefore on revenue. One such measure was the introduction of levies on fuel and surtax (VAT) on goods and services, without studies to determine the overall economic impact. The result was the increasing strangulation of the private sector and stagnating growth.

Parastatals

In the late 1990s, many government institutions, in particular parastatals, started to experience financial difficulties, which contributed to the worsening economic environment. The institutions' poor performance was mostly due to bad management practices. Employees and board members were not recruited on merit but rather for political reasons. Due to lack of funds, parastatals began borrowing from commercial institutions, with government acting as guarantor. When the parastatals eventually collapsed, government repaid the loans from the national budget, which had not made provision for this. The result of these repayments not being factored in at the budget planning stage was over-optimistic budgets for the rest of government. This in turn had a negative effect on government's fiscal performance, such as arrears, and seriously undermined the credibility of the budget.

When government realised the severity of the problem, it started to implement a policy of privatising the institutions to reduce its exposure. However, with hindsight, it is clear that this approach was not properly considered in terms of the overall medium-term impact, as the privatisation of the institutions had a number of negative consequences. For example, when the new businesses were established, they reduced staff. The resulting job losses not only affected demand in the economy, but also put a greater burden on the state.

Poor budgetary discipline and low credibility

An underlying factor in the tale of Malawi's woes in 2002/03 and 2003/04 was the budget's general lack of credibility. This was fuelled by the general lack of confidence in revenue projections; weak controls on spending, which continued without due regard for spending limits; the creation of arrears; and a general lack of confidence on the part of the private sector and funding partners in government's ability to deliver on its fiscal and macroeconomic plans. The lack of credibility had its roots in the progressive weakening of budget processes. By 2002/03 and 2003/04, government was showing blatant disrespect for the budget. Resources were not being allocated to sectors and ministries on the basis of merit; generally, the 'loudest' and misbehaved institutions were funded at the expense of core budget areas. More resources were allocated to those sectors that were favoured by politicians and not according to the country's priorities and needs. This scenario resulted in dwindling economic growth and development, as priority sectors (such as agriculture and food security, irrigation and water development, transport infrastructure development, education and health) were neglected. The poor discipline, combined with the intensifying cash flow crunch, resulted in the ministries that were not receiving allocations due to them running up arrears in efforts to keep essential services running.

In addition, before 2002, there was limited understanding in government of government's economic programme and the relationship between fiscal and monetary operations. There was also much off-budget expenditure, particularly of donor funds to purchase various inputs – such as staff and programme goods and services – for government programmes. In an attempt to capture all revenue and expenditure in the budget process, this commodity aid (aid in the form of goods and not cash) was correctly brought in the budget. At the same time, however, ministries receiving commodity aid suffered drastic cuts in their budgets because government had to try and remain within IMF agreed figures, including expenditure on commodity aid. This change was not adequately explained and also contributed to the low credibility of the budgeting process.

Increasing arrears

The growing stock of arrears put great pressure on the state's balance sheet and had a ripple effect on the private sector. Apart from the bailout of parastatals that absorbed available cash and the favours bestowed on some ministries in the process, the arrears were the result of poor practices in a number of arenas. These included the following:

- In 2000, government sold maize stocks to defray handling costs. This was a poor decision as the maize stocks were sold at a very low price. After the sale, the country suffered serious droughts and government was forced to provide funds for maize purchases. These payments had not been anticipated and resulted in further unplanned absorption of available cash. In 2002, in order to do this, some ministries were under-funded. However, the affected ministries were not properly or timeously informed about the funding changes, and they continued their planned spending and so began accumulating arrears.
- Government initially earmarked the proceeds of the privatisation process for investment projects. However, adequate measures to plan, approve and manage projects were not put in place. Projects were planned centrally without adequate consultation with beneficiary institutions, which resulted in poor specifications and poor links with current spending. Overall, projects funded were inappropriately appraised and approved and often proceeded on the basis of inaccurate financial projections. The overall result was products that did not meet users' requirements. Accordingly, contracts had to be adjusted, resulting in cost overruns that led to increased arrears.
- The ministries that benefited hugely from commodity aid needed to adjust their cash expenditures within their aggregated ceilings. But budget reform was not well understood or supported, resulting in ministries spending cash against budgets, also contributing to arrears.

Unpredictable donor funding

Between 1999/2000 and 2003/04, government's integrity in handling funding deteriorated progressively. This was due to the lack of financial discipline at the highest political level, among senior government officials, and in all tiers of government. The waning credibility of the fiscal system was a concern to donors, which led to more unpredictable inflows of donor funding. So when anticipated donor funding did not arrive, government resorted to cash rationing and arrears were accumulated in the process.

Domestic borrowing and financial sector policy

When anticipated donor funds did not materialise and arrears were mounting, government started borrowing from the domestic market through the Reserve Bank of Malawi (RBM). This led to excess liquidity in the market. The RBM operated at a loss due to interest paid in the open market. This in turn affected the RBM foreign reserves. The result was rising interest rates and reduced borrowing by the private sector, further affecting the performance of the economy. Before 2004/05, government

lacked a financial sector policy and this led to high interest rates on treasury bills. Commercial banks resorted to investing more in treasury bills than other sectors of the private sector. This resulted in low levels of investments and savings.

Summary

Poor policies and practices related to revenues, parastatals, and the creation of arrears and the consequences of short-term, emergency problem-solving initiated the downward economic spiral in Malawi. These worked together, resulting in low credibility of the budget and instability of donor funds. The short-term response, increased domestic borrowing without good financial sector policies, added to the country's woes.

3.4.3 Policies/measures and their effects during the period of improved macroeconomic management (2004/05 to 2006/07)

The new government that came into power in 2004/05 immediately recognised the importance of establishing the right medium-term policies and practices to improve economic stability. The period between 2004/05 and 2006/07 can be described as one of improved macroeconomic management, as the economic indicators below show. Many factors contributed to the upturn, leading to an improved macroeconomic environment.

Table 3.4.2: 2004/05 – 2006/07 and beyond:
Improved economic indicators

Economic indicator	2004/05	2005/06	2006/07
GDP growth (real)	3.5	5.1	7.0
Domestic interest as % of budget	17.12	11.73	9.8
Net foreign assets	5.8	9.2	29.7
Inflation rate*	11.4	15.5	13.9
USD exchange rate	123.0	139.0	140.6
Domestic debt/GDP	17.3	14.4	10.8
Treasury bill interest rate (average)	24.5	22.4	18.0
Overall balance (including grants) as % of GDP	-3.9	-0.8	-1.2
Domestic financing as % of GDP	2.2	0.2	-0.04

The main objective of the new government in 2004/05 was to improve the economy and the welfare of the rural masses. The political will to effect economic change was evident. The president, the cabinet and senior government officials all supported policies aimed at better macroeconomic management. The package of fiscal policy and financial management objectives and benchmarks agreed with the IMF included:

- zero borrowing from commercial loans
- compilation of quarterly financial reports on the ten major parastatals to avoid surprises
- frequent in-year reporting of expenditure commitments to monitor accumulation of arrears
- monthly reporting on import backlog by the RBM
- a limit on government salaries and wages and on discretionary expenditures.

In an effort to build credibility and stabilise external financial support, government agreed to the IMF staff monitoring programme and to align its policies with the IMF. In addition to these benchmarks, government also drew up a complementary set of policy targets. Other key aspects of the comprehensive economic and fiscal reforms:

Domestic debt reduction

Government implemented a policy to reduce domestic borrowing from the commercial banks and to manage budget balances to reduce debt over the medium term. This resulted in low interest payments as a percentage of the budget, which made resources available for discretionary spending. It also resulted in the lowering of interest and inflation rates, which have created a conducive environment for private sector development. This in turn has had a positive impact on revenues, bringing in additional cash to repay debt and fund necessary services.

Efforts to audit and clear arrears

In 2004/05, government started to systematically audit and clear arrears. All government ministries and departments that had accumulated arrears between 2002/03 and 2003/04 were instructed to have their arrears audited and paid through the accountant-general. This has resulted in more predictable funding for current service provision to ministries and less arrears. This exercise has also unlocked resources for private sector investment, and donor confidence has increased since these changes started to take effect.

Introduction of subsidised farm inputs and irrigation farming

In 2004/05, government introduced the fertilizer subsidy programme to improve agricultural productivity and ensure food availability. The programme was introduced to allow poor farmers access to cheap fertilizer to increase their produce. Increased food production has helped to bring down the inflation and interest rates and thus improved macroeconomic environment. This is because in Malawi the price of maize

is the most sensitive macroeconomic variable, immediately affecting the inflation rate. In addition, consistent and foreseen medium-term spending has reduced the medium to long-term risk to the budget of expenditure on emergency food security.

Improved tax reforms

In 2002/03 and 2003/04, it was difficult for private businesses to make a profit as most of their returns were paid out as tax. But between 2004/05 and 2006/07, government realised that it had to develop a medium-term programme of tax reform that would broaden the tax base, improve compliance, increase funds available for private sector re-investment and ultimately increase revenues. The tax reforms that were put in place have increased private sector confidence in government, evident in new investments.

Improved exchange rate

In order to support the exchange rate, government introduced monetary performance criteria like the RBM's net domestic assets and net foreign assets. The exchange rate of the local currency to major currencies is stabilising and this has reduced the incidence of forex hoarding and dealings on the black market.

Improved government payment system

In 2004/05, government introduced an integrated financial management information system (IFMIS), which is resulting in improved financial management discipline, faster printing of cheques and the smoother implementation of ministries' programmes and activities. While there have been some problems in the integration of budgeting and financial management through the IFMIS, some good results are evident on the payments side. Further, the automation of payment systems has improved the production of government year-end financial accounts, thus positively affecting accountability and budget discipline.

3.4.4 Lessons learned

The Malawi government has learned important lessons in its efforts to improve the macroeconomic environment, which deteriorated between 1999/2000 and 2003/04:

- The need for a medium-term perspective in fiscal and budget planning. For example, capacity to assess the medium-term impact of choices and decisions is necessary. This makes it easier to make hard budget choices in earlier years to unlock resources in the medium term, and prevents situations arising where short-term decisions with disastrous consequences are made. Also, a

medium-term perspective allows for trade-offs to be made over time, where areas that are not funded or addressed in the immediate cycle can receive attention in subsequent cycles. A medium-term perspective makes risk clearer and disciplines decision-making.

- The need to start developing policies with a thorough consideration of medium-term affordability in a well-understood macroeconomic and fiscal framework.
- The need to be conscious of the country-specific links between public policy, public finance, public management and the wider economy. Many factors featuring in both the economic decline and recovery in Malawi are country-specific: for example, the introduction of agricultural subsidies is a positive fiscal and budget instrument given the current structure of the Malawi economy and its current position on a development trajectory.
- The willingness to change. Government must be flexible enough to introduce reforms which would lead to economic growth and development.
- The need for a comprehensive view. Within overall macroeconomic, fiscal and budget policy, government should avoid taking discrete decisions in narrow policy areas. First, these areas are all inter-linked and government needs a comprehensive review to identify underlying causes and isolate which levers will address policy problems most effectively. Second, there is a need for government to strategically sequence its policy interventions in the process of recovering the economy. Third, budgets need to be comprehensive to address all areas of national importance, to ensure that all policies come into view periodically and to ensure that the impact of existing policies is taken into account when new policies are formulated across government. Finally, there is a need for co-ordination and collaboration across government departments.
- The need to acknowledge external incentives. While pressure from development partners and other external stakeholders can be dysfunctional, it can also be harnessed by the finance ministry to assist in the implementation of domestically motivated reforms.

3.4.5 Conclusion

Between 1999/2000 and 2003/04, Malawi suffered severe economic decline, largely fuelled by successive policy decisions that attempted to address immediate crises without due consideration of the best medium-term options. The situation started to improve from 2004/05, when a new government was elected into power and

changed its policy approach with a comprehensive medium-term, macroeconomic and fiscal focus. The macroeconomic environment improved when government reduced domestic borrowing and had to build donor confidence. It is the hope of every Malawian that political will and the new reforms in place will continue to create a conducive environment for economic growth and development.

3.5 Rwanda: Medium-term perspectives pivotal in post-conflict recovery and growth

Frances Cossar and Elias Baingana

3.5.1 Introduction

In 1994, Rwanda suffered one of the most acute conflicts observed in recent decades. The challenges of rebuilding the country in the aftermath of the genocide were significant and the positive progress Rwanda has made in the last 14 years is admirable. The human capital and institutional capacity of the executive government were all but destroyed. Not only was the government in a very weak position to govern the country but the needs of the country were vast: with 40 percent of the population displaced and many families plunged into poverty due to the conflict (70 percent of the population was living below the poverty line in 1997⁴).

This paper arises out of a seminar given at the 4th CABRI Annual Seminar in December 2007, where medium-term budgeting issues were discussed and specifically, in relation to a post-conflict situation, as in Rwanda. The paper explores

both the difficulties and benefits of taking a medium-term perspective in government’s planning and budgeting process. Rwanda’s public financial management reforms have included the introduction of a medium-term expenditure framework (MTEF) to bring a practical medium-term perspective into the process. We will argue here that budgeting for the medium term has been crucial in the progress Rwanda has made in achieving stability and growth.

After introducing the key challenges facing government since 1994, the paper will explore the impact medium-term budgeting has had on achieving growth and development goals between 1996 and 2002, and then between 2002 and 2005. Conclusions will be drawn regarding lessons that can be learned for other post-conflict situations, the sequencing of key public finance management reforms, and the ongoing challenges that Rwanda faces.

3.5.2 The pre-conflict years

Before the conflict began in April 1994, the economy of Rwanda was already in decline. Stagnation in GDP growth in the 1980s is demonstrated by the fact that GDP was lower in 1991 than it was in 1984⁵ (Figure 3.5.1). The decline in economic activity can be attributed to poor economic management, debt accumulation and structural constraints to growth. The main constraints included declining agricultural productivity, and barriers to trade such as the country being landlocked and a narrow economic base from which to expand exports. Although the further decline in the economy was exacerbated by the conflict, there was already a downward trend in economic activity preceding 1994. While inflation was under control before 1994 due to government price controls, it jumped from 4.2 percent in 1990 to 50 percent in 1994⁶ (Figure 3.5.2).

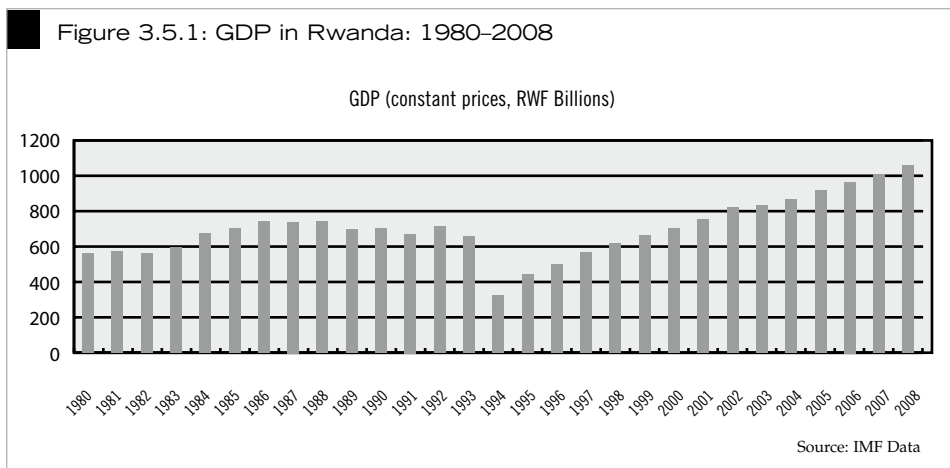
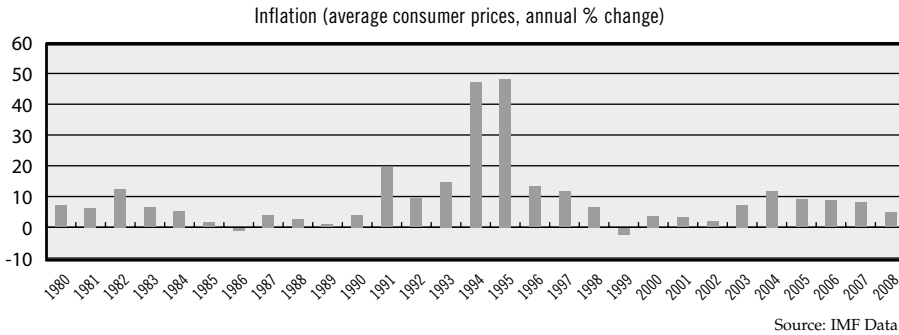
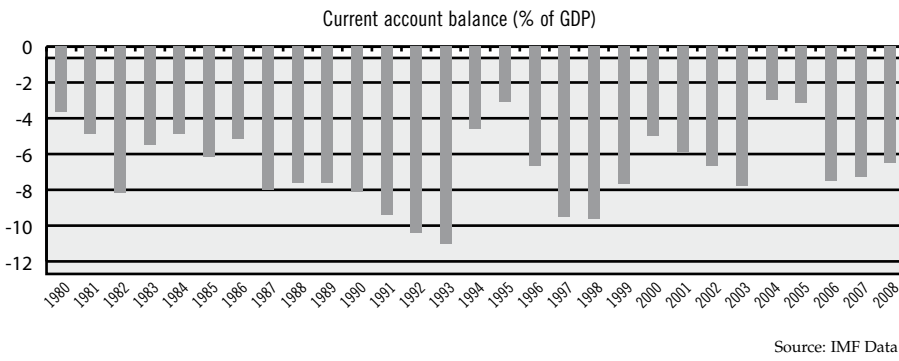


Figure 3.5.2: Inflation in Rwanda: 1980–2008



The instability of Rwanda's economy in the years before 1994 is further demonstrated by the volatility of the current account balance (Figure 3.5.3). The current account deficit grew significantly between 1987 and 1993 for several reasons: donors were withdrawing funds due to the escalating conflict; imports were high to support the war; and exports were not rising as economic activity lessened. This pattern is also evident in the post-conflict years as aid was withdrawn when conflict on Rwanda's borders escalated, but the current account deficit lessened immediately after 1994 as international emergency assistance flowed in.

Figure 3.5.3: Current account balance in Rwanda: 1980–2008



It is clear that many of Rwanda's economic problems existed before the genocide and war. For example, there was weak institutional capacity, poor development of human resources and high levels of accumulated public debt. However, the conflict served to exacerbate some of the problems and present new ones.

3.5.3 The post-conflict years: The economic scenario

By 1996, much of the productive infrastructure had been destroyed in the conflict and an entire generation of skilled workers (teachers, doctors, public servants and private entrepreneurs) was lost. An example of the impact this had on the ability of the executive government to function effectively is in data collection, as all previous data and the capacity for data collection were destroyed. Insufficient data made policy-making and budgeting very difficult. The National Institute of Statistics of Rwanda (NISR), set up in 1996, was one of the first institutions established to address this, with technical assistance from UNDP, together with the Ministry of Finance and Economic Planning in 1996.

Total external debt stock for 1995 stood at \$1,063million,⁷ which was 85 percent of GDP. Servicing this debt was a major burden on the Rwandan government's fiscal balance. Combining this unsustainable debt burden with a low tax base and high demands for spending on reconstruction and social sectors, led to a high primary fiscal deficit.

The key issues facing government through the post-conflict period were the high debt burden, sporadic flows of aid, a high primary fiscal deficit, and the need to achieve macroeconomic stability and rebuild government's institutional capacity. These themes will be tracked in the following description of the post-conflict years to illustrate how a medium-term perspective helped the recovery and reconstruction.

3.5.4 The post-conflict years: Recovery and reconstruction (1996–2002)

Several key reforms were undertaken in this period to re-establish the economic and fiscal management capacity within government, alongside the tackling of Rwanda's extensive external and domestic debt burden.

Tax administration

In 1998, the separate customs and tax collection functions of government were restructured into a single tax collection and administrative institution called the Rwanda Revenue Authority. The aim was to stamp out corruption and improve revenue collection. An entirely new staff complement was recruited from the private sector and a new institutional structure was put in place. New laws relating to tax were introduced and the processes were documented to ensure the transparency of the system. VAT was introduced and tariffs were restructured. (The highest level of import duty was reduced from 160 percent to 30 percent). There was also a deliberate shift towards consumption taxes.

The government had previously been financing its spending by borrowing large

amounts from mainly public enterprises (including Rwandatel and Electrogaz). This domestic debt was consolidated as part of the cross-debt settlement in 1999. Government agreed to offset taxes owed by those enterprises against the debt government owed to them.

These reforms to the tax administration and domestic financing of government spending served to put in place the necessary systems for efficient tax collection. Tax revenues have gradually increased since 1996 and revenue collections have become more reliable. This is an important step in the move towards medium-term-budgeting – without a reliable and stable tax collection system, it is not possible to commit to policies beyond a single year.

Donor financing and debt relief

The debt burden on government was significant and servicing the debt was severely reducing the expenditure that could have been allocated to social and productive sectors. In 2000, Rwanda reached the Highly Indebted Poor Country (HIPC) debt reduction initiative decision point. The reduction in debt servicing costs thus freed up government resources to be spent in the domestic economy. However, Rwanda only achieved a sustainable debt position when the Multilateral Debt Relief Initiative (MDRI), was agreed in 2005, which brought much more extensive debt relief. Government's demobilisation and reintegration programme was heavily financed through the International Development Association (IDA) and other bilateral donor assistance. This donor financing facilitated a shift in spending from security and emergency expenditure, to social sectors and other priorities such as justice, reintegration and governance.

The civil service

Much of the public sector workforce left as refugees in 1994, returning later to take up their previous jobs. In the meantime, others had filled the vacancies created immediately after the genocide. The result was a bloated civil service with much duplication of work. One of the conditions of the IMF's Enhanced Structural Adjustment Facility (ESAF) in 1998 was to restructure the civil service. A public service employee audit was conducted and then a programme of retrenchment was implemented by the Ministry of Public Service, Skills Development, Vocational Training and Labour, which included incentives such as early retirement. This extensive retrenchment programme led to a successful reduction in government's wage bill. Given the large proportion of the budget that was allocated to government wages and salaries, this helped to reduce the primary fiscal deficit.

IMF structural adjustment facility

The ESAF preceded HIPC and was the first attempt to reduce Rwanda's debt burden in 1998. As part of this, donors established the multilateral debt transfer fund. Donors put money into this fund to help Rwanda pay its external debt. Through this initiative, Rwanda's external debt was consolidated. However, the targets set by ESAF were not effective. For example, monetary targets were met only on four days in the year, just before the IMF assessment.

Several key reforms were implemented as part of ESAF. The exchange rate was liberalised with the introduction of a forex auction system in 2001. Trade liberalisation was introduced with further tariff restructuring. In particular, export taxes were abolished and the import licensing system was abandoned. Through ESAF, many important reforms were made, but it ran for only one year before being replaced by the Poverty Reduction and Growth Facility (PRGF) in 1999, in line with the worldwide shift in lending instruments by the IMF.

At this stage, medium-term budgeting through the MTEF was starting to appear on the reform horizon. During the 1990s, although the high debt burden was beginning to be addressed, the capacity of the executive government was being built up and public financial management systems were being established, a clear medium-term perspective was difficult to achieve. Donor financing was unpredictable and highly conditional, which made making accurate projections of aid flows very difficult. The expenditure demands of the country were changing rapidly with the return of many new and old refugees. The needs of the country were also changing rapidly from the initial emergency situation to a post-conflict reconstruction environment. Initially, policies had to be focused on the short-term humanitarian needs of the people and the lack of resources made a longer-term focus on investment in productive activities difficult.

However, by the early 2000s, Rwanda was moving out of the transition period and looking forward to the long-term goals of the nation. In August and September 2003, presidential and parliamentary elections were held for the first time since 1994 and government formulated its long-term plan for Rwanda, Vision 2020. It is at this time that the MTEF was introduced and a medium-term perspective was incorporated into Rwanda's planning and budgeting process.

3.5.5 Macroeconomic management and stability (2002–2005)

Average annual GDP growth between 1996 and 2002 was rapid, at around 9.3 percent. By 2002, GDP had recovered to pre-1994 levels. The challenge facing government in 2002 was to sustain that growth. While the huge task of recovery had been achieved, the focus had to shift to poverty reduction and sustained and stable economic growth. What follows is a discussion of the main challenges to macroeconomic stability and growth, and the contribution of a medium-term perspective in budgeting.

Aid on budget

After the war, many NGOs in Rwanda kept aid off budget. As there was no credible budget process, donors were reluctant to put their aid on budget. For example, between 1994 and 1997 the World Bank reconstruction project was carried out entirely through NGOs. However, from 1997 onwards, the project began putting aid on the budget and through the central bank. Other donors such as the Department for International Development (DFID) were helpful in convincing others to move more aid on budget.

For this process to happen, donors had to have confidence in the public finance management system, especially the budget process. This is where the MTEF, which was introduced in 2000, started to become an important instrument. Its ability to provide a medium-term perspective for project prioritisation and the development of medium-term plans such as the poverty reduction strategy paper (PRSP), allowed donors to align their spending with government's priorities and put their aid on budget. When aid money is brought on budget in a medium-term environment, donors have significantly more access to processes deciding priority expenditures. While this is an incentive for donors to bring money on budget – in turn strengthening domestic systems in the interest of government – government ownership of the planning and budgeting process is critical. In the design of its MTEF processes, Rwanda has therefore sought to manage relationships with donors.

Dutch disease⁷

Aid flows to Rwanda have increased significantly in recent years. Not only was there comprehensive debt relief in 2005 through the MDRI, but donors such as DFID and the World Bank have increased budget support. Other global initiatives, such as the Global Fund, have also increased project grants. In this context, Dutch disease as a result of scaling up of aid was and remains a serious threat to macroeconomic stability in Rwanda. However, between 2002 and 2005, the symptoms of Dutch disease were not experienced. Exchange rates and inflation have been relatively stable, indicating the inflationary effects of large aid inflows have not occurred. For example, the currency only appreciated by 0.3 percent last year.

Rwanda has used two main areas of policy to minimise the risks associated with Dutch disease. First, by using a mix of selling forex reserves and treasury bills, monetary policy has allowed the currency to fluctuate freely and has mopped up any excess liquidity in the economy. The combination of these two actions is important for the sustainability of monetary policy. Second, the nature of government spending can help to ensure an adequate absorption of aid. Through increasing the import component of the budget, foreign currency can be spent directly on imported capital

goods. Thus government can avoid aid money entering the economy as cash. This protects the economy from inflationary and exchange rate pressure.

This combination of monetary and fiscal policy was applied successfully between 2002 and 2005, but co-ordination between monetary and fiscal management needs to be improved to ensure Dutch disease does not cause macroeconomic problems in the future.

Aid dependency

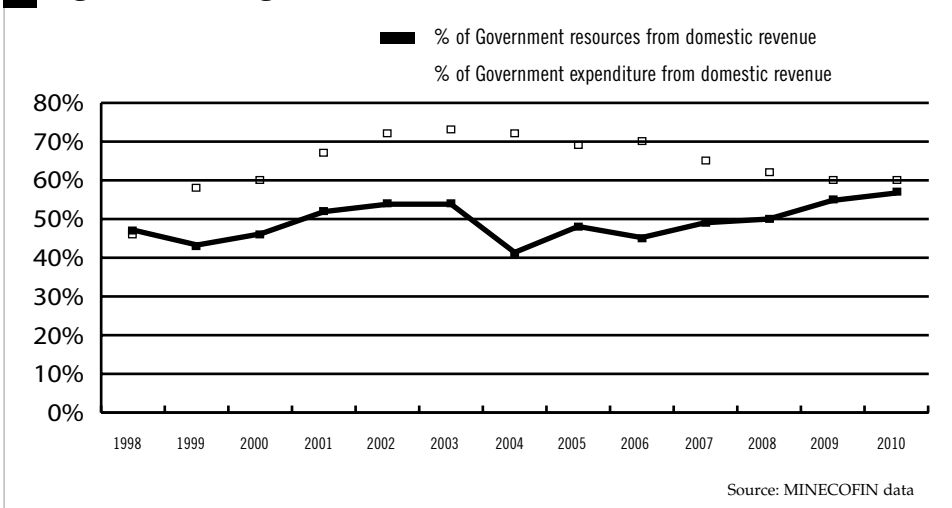
It has already been noted that a considerable threat to fiscal planning and macroeconomic stability is the volatility of aid flows. The volatility in the current account deficit (Figure 3.5.3) can be partly attributed to uneven aid flows. A medium-term approach to budgeting is highly sensitive to donors' aid commitments. For estimates of future revenues to be accurate, it is necessary for donors to commit in advance and on a rolling basis to funds for three years, in line with Rwanda's three-year MTEF structure. Despite the progress in donor relations and the reliability of Rwanda's government, this forward commitment of funds is not common. For example, donor support to Rwanda was delayed due to concern over Rwanda's involvement in the Democratic Republic of Congo in 2003, leading to aid disbursement being postponed, in the case of some support for more than a year. An event like that makes sustained macroeconomic stability difficult, as well as the management of government spending.

In 2006, Rwanda introduced its policy on aid. Among other things, the policy document states a preference for budget support over project funds, and for aid to be in the form of grants rather than loans. It also outlines donors' responsibility in reporting on aid and the relationship between donors and government. It is clear that government has taken its leadership role in its relationships with donors very seriously. The MTEF occupies a significant part of this relationship: donors are able to see government's medium to long-term priorities and can agree on funding certain medium-term expenditures on that basis.

However, Rwanda's MTEF still needs to be greatly improved. While structures for co-ordination and consultation have been set up, these need to be strengthened. In the context of decentralisation, the MTEF should also expand its mechanisms to de-fragment budgeting between source of funds and objectives and locations of spending. Most recently, the country has introduced a consolidated, programme-based classification system for budget documentation. While this has improved the transparency and coherency of spending, capacity still needs to develop to use the instruments better to improve the effectiveness of spending. Finally, longer-term plans such as the economic development poverty reduction strategies (EDPRS) also require improved multi-year funding plans.

The problem of aid dependency in Rwanda is real and unlikely to disappear in the near future. Around 50 percent of government's resources come from external grants and loans, while approximately 60 percent of government expenditure is recurrent. This is shown by a consistently negative primary fiscal deficit, which would leave Rwanda unable to cover its essential costs if donor financing were withdrawn. There has been improvement in recent years as Figure 3.5.4 shows but more progress will need to be made in subsequent years to ensure primary fiscal balance is positive and Rwanda can become less dependent on aid.

Figure 3.5.4: Budget mismatch in Rwanda: 1998-2010



3.5.6 Conclusion

Four key benefits of a medium-term perspective

The medium-term perspective in planning and budgeting has been crucial in the period 2002–2005. It has assisted government in a number of critical strategic areas. First, macroeconomic stability has been achieved through taking a longer-term view of planning and understanding the linkages between economic, fiscal, monetary and budget policy over the medium term. Second, donors have been able to partner with government through the medium-term perspective and thus reduce the risks of aid volatility and the debt burden. However, the increase in aid has not reduced the primary fiscal deficit as the scaling up of aid has led to an expansion in government expenditures. But with a medium-term focus, expenditures have increasingly been focused on investments which will lead to long-term growth, rather than only on sets of activities with only short-term benefits.

It is the ability to assess the trade-off between long and short-term benefits of policies that has presented a third clear benefit of a medium-term perspective to government. Macroeconomic trade-offs are important aspects of trying to accelerate and sustain economic growth. Investment in physical and human capital has to be made now as a basis for growth in the future. However, high levels of investment will bring inflation. If planning is done for the medium to long term, it is much easier to accept the inflationary effects of a significant increase in spending, if that spending is going to investment. At the level of choices between spending options, medium-term budgeting provides a clear framework for trade-offs between investment and recurrent spending of government, thereby helping to ensure that maximum spend goes to investment. For a country like Rwanda, in which fiscal policy is the main instrument for controlling macroeconomic balances, a medium-term perspective has been invaluable.

A fourth important benefit is of course the ability to establish medium to long-term spending priorities related to economic growth and development goals, and to measure progress in funding priorities and reaching goals. The policy stability offered by a medium-term perspective reduces the risk of budget fragmentation through responding blindly to short-term needs, a big drawback of annual budgeting systems. This benefit, however, is more tangible in the arena of budget policy than fiscal policy, the focus of this paper.

Strategic sequencing of reforms

The Rwanda experience also brings lessons in the sequencing of reforms to produce a quality MTEF. The reform of tax administration institutions ensured that domestic revenue was more predictable and reliable. Rwanda's leadership in donor relations has been crucial for improvement of the predictability of external revenue. In determining priority expenditures, a clear set of priorities through Vision 2020 and PRSP/EDPRS has ensured that fiscal policy has helped to sustain macroeconomic stability. In turn, good macroeconomic management has made the MTEF more credible, with greater stability in responding to the needs of the economy, drawing on its resources.

In introducing a medium-term perspective to budgeting, the sequencing of public finance management reforms has been crucial. In the first instance, central institutions were set up such as the Ministry of Finance and Economic Planning (MINECOFIN) the Central Bank of Rwanda (CBR) and the NISR by 1996. Subsequently, a credible budget process and accounting system were introduced by 1997. In 1998, the CBR was given autonomy in monetary policy control. It is only after these reforms – all contributing to macroeconomic stability – that the MTEF and strategic planning framework were implemented in 2000.

Ongoing challenges

Challenges still remain. The shortage of skilled staff across government, coupled with a high turnover of staff, make further improvement to the MTEF difficult, such as deepening processes in the line ministries. Despite improvements in donor relations, aid volatility and aid dependency will be problems for years to come. However, the MTEF has greatly enhanced the contribution that sound planning and budgeting can make to Rwanda's growth and development. Its improvement will continue to be a focus of public financial management reform strategies and will play a critical role in the country's future.

Endnotes

- 1 This paper is based on a number of IMF reports. The East AFRITAC region includes Eritrea, Ethiopia, Kenya, Malawi, Rwanda, Tanzania and Uganda.
- 2 The mandate of many RAs in the region extends beyond tax and customs administration, covering a range of revenue handles from major to minor. All East African RAs collect taxes and fees associated with motor vehicles. A few RAs are tasked to collect a multiplicity of government fees and charges, ranging from passport application fees to traffic fines.
- 3 Gauthier B and Reinikka R (2001) *Shifting Tax Burdens through Exemption and Evasion: An empirical investigation of Uganda*. Policy Research Working Paper 2735, World Bank, Washington DC.
- 4 HIPC decision point document.
- 5 IMF Data: Real GDP was RWF 674 billions in 1984, and RWF 672 billions in 1991.
- 6 IMF /MINECOFIN data.
- 7 The phenomenon that occurs through the effects of large inflows of foreign exchange, including the appreciation of the exchange rate, increased inflation and changes in economic activity towards the non-tradable sector.

4

Addressing incrementalism and expenditure rigidities

4.1 Introduction

The rules that govern budgeting are key to embedding a medium-term perspective. Such a perspective in turn is necessary to facilitate strategic budgeting, which means both overcoming structural budget constraints and the default inclination to budget by adding increments to input costs. Just adding a mechanism – albeit an additional budget document, budget information or process – to the existing budgeting system and calling it a medium-term expenditure framework is not sufficient. All of the budget preparation process should be re-engineered towards a medium-term horizon. Previous resource volumes contain chapters on the kind of changes that are required: reforming classification systems, embedding budget programmes, strengthening parliamentary oversight, setting up monitoring and evaluation systems, to name a few. This chapter builds on this work by looking at two particular issues that bedevil country efforts to budget better by making the medium to long term count: how to budget for capital or development projects and how to use ceilings and baselines so that spending agencies are forced to look at the medium term.

In the first paper, Kuben Naidoo, Head of the South African Budget Office, shares the shortcomings and benefits of a budget structure that does not clearly separate

capital projects from operational spending. He elaborates the adjustments made to ensure that budgeting rules support planning and budgeting for the lifetime of a project and effective monitoring of project spending within medium-term baselines. The paper contains valuable insights for countries considering an integration of recurrent and development budgets. The paper also contains a text box (Box 4.2.1) prepared by Moeti Ekenyane from the Ministry of Finance and Development Planning in Botswana, setting out the capital budgeting system of Botswana. In contrast to South Africa, capital spending in Botswana is planned through a separate process and is approved in a separate development budget.

The final two papers take up the ceiling and baseline question and discuss how Ghana and Namibia have approached the use of ceilings and baselines in the budget process. In both cases spending ministries are given strict ceilings within which to plan. However, in the Namibia system the ceilings roll over unchanged prior to the process of central budget scrutiny and negotiation. Chris Claassen and Ruth Mukono from the Ministry of Finance explain in their paper that adjustments occur on the basis of this process, against specific rules, after which ministries have to submit finalised plans. In Ghana – as set out by Kwabema Adjei – Mensah, Budget Director – the rolled-over baselines are adjusted centrally – and largely finally – before this central scrutiny of detailed spending proposals. Juxtaposed, the papers show that while there are pros and cons either way to ensure that ministries are strategic in their budgeting, the important issue is clear criteria for adjusting ceilings and discipline in using those criteria.

4.2 Capital budgeting in South Africa

Kuben Naidoo

4.2.1 Introduction

Capital spending is different from recurrent spending. While there are theoretical debates on the precise boundary between capital and recurrent spending, there is a theoretical basis for arguing that the delivery of capital goods requires special attention in a budgeting system. There are logical reasons for the inherent bias against capital spending. These need to be understood and actively countered in the design of a budgeting system.

Standard growth theories based on Solow or other classical models all argue that capital is an essential element of growth. The public sector delivers capital goods both because it contributes towards higher long-term growth and because it enables the delivery of other public services. More precisely, the quality, availability and distribution of capital stock in the public sector are key determinants of the quality and distribution of public services. While many public services such as education, health, policing and welfare services are labour intensive, the quality, availability and distribution of capital often determines the quality, scope and distribution of these services.

This paper is based on a presentation delivered at the fourth Annual CABRI Seminar in December 2007 in Accra, Ghana. The paper starts by setting out elements of a theoretical framework for budgeting for capital goods in the public sector; it then raises some policy questions that keep budget officials awake at night; and, finally, it describes South Africa's capital budget system.

Elements of a theoretical framework for capital budgeting

A key to properly structuring capital budgeting is being clear about how capital spending is defined and that it only indirectly contributes to service delivery. The direct contributor is the total public asset base. In the first section, the paper explores the implications of these analytical distinctions for capital budgeting systems and decisions.

Conceptual and policy issues of capital budgeting

The next section of the paper deals with some issues that have probably puzzled budget officials for many decades. Is there an optimal level of capital spending? How does one deal with optimism bias? How much should be spent on maintenance? What role can public private partnerships (PPPs) play in delivering capital goods in the public sector? How does a country avoid boom – bust periods in its infrastructure sector? This paper does not deal extensively with these issues, but rather raises the questions and provides some suggestions for how they can be handled.

South Africa: A single budget process

Budgeting systems evolve with time to take account of the prevailing political, social and economic context. Similarly, capital budgeting has changed over time and will continue to change. There is no single ideal budget system and budget systems can almost never be simply transplanted in another country. For this reason, this paper must be read from the perspective of understanding why South Africa's budget system operates as it does and what lessons this holds for other countries.

The paper will attempt to set out the economic and public finance reasons for spending on capital and deal with the public finance questions on the most appropriate ways to budget for capital. In general, South Africa's budget system does not have two separate processes to budget for capital. A single budgeting process is used with a single decision point for all budgetary proposals. Nevertheless, capital is seen as different and is treated somewhat differently within a single budget process.

With the exception of decisions on a small number of large capital projects, decisions on which school to build or where to build the next police station or what size a clinic should be are made by line departments, and often at sub-national government level.

During the budget process, in one respect, capital and recurrent expenditure are treated in a neutral fashion. This implies that the medium-term decisions on whether to hire more police or to buy more vehicles are made by policy-makers inside the police force. The extent to which school building is a priority relative to more teachers or school books is also a policy decision taken by education officials. In another respect, the budget process protects capital spending since short-sighted managers may choose to underfund capital spending, potentially threatening the long-term sustainability of delivering services. This paper will deal with how this contradiction is balanced in the budget process.

4.2.2 Some theoretical perspectives on budgeting for capital

Economists differentiate consumption from investment because the benefits accrue over different timeframes. Consumption is spending that gives immediate benefit while investment allows for a stream of benefits over a longer period. Classical economic models put capital stock and the supply of labour as the two key elements that determine long-term economic growth. Later models add technology and human capital, but the stock of capital is indisputably a key element of long-term growth.

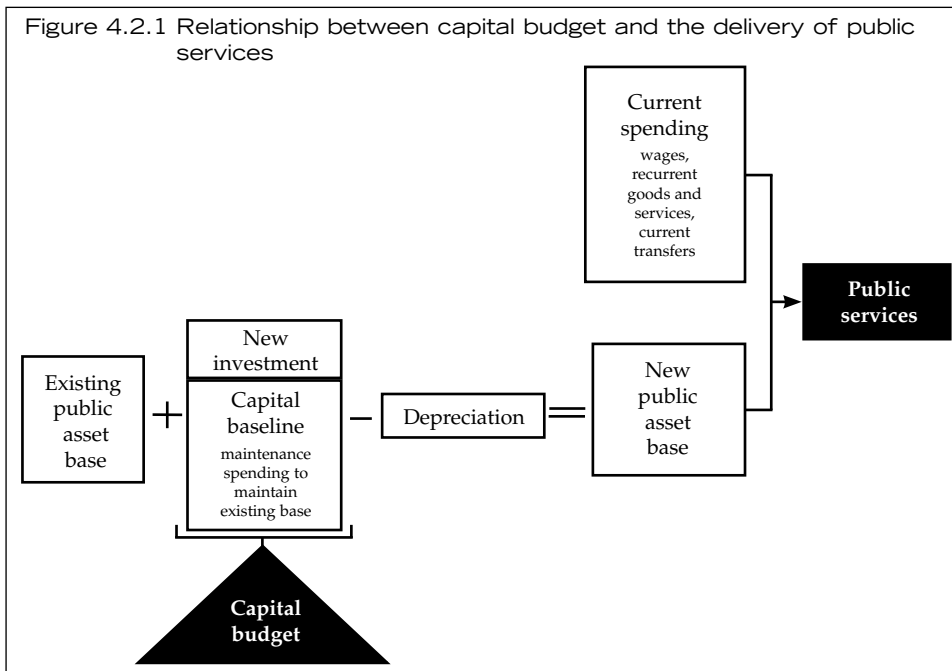
In an economy the component parts of the stock of capital differ in nature. Some capital goods enable the efficient functioning of the private sector while others enable the public sector to deliver services that are essentially public or mixed goods. Roads, bridges, traffic signs, network infrastructure, ports and rail are goods that enable private economic activity. Governments also deliver social services such as education and health and services directly to households such as water, sanitation and refuse removal.

This paper will not go into the debate on whether the public sector or the private sector should deliver capital goods of varying types. Nevertheless, the economics of delivering goods such as roads are different from that of water treatment plants; the economics of airports are different from those of building schools.

For the purposes of this paper, I wish to define capital spending in the public sector as spending that improves public services in the long term, spending for which we expect a long-term return or spending that creates public assets. Building hospitals and schools is considered capital spending but teacher training and redundancy costs are not considered capital. The issue of whether teacher training is capital or not is a moot point. It is probably on the boundary between what is considered capital and what is not considered capital. One can argue that teacher training improves public services over a long period – it depreciates in the sense that its benefit erodes over time. In some accounting systems, staff training is considered a capital item. For the purposes of this discussion, however, it is not considered capital since, in a

conventional accounting sense, we cannot add this value to the balance sheet.

Conventional thinking goes that in the public sector capital spending plus recurrent spending delivers public services. This is not true. A stock of capital plus recurrent spending delivers public services. Capital spending adds marginally to that stock of capital spending. Given that the public asset base depreciates, spending has to take place to simply maintain the asset base at the level it was a year ago. The following figure illustrates this, helping to provide a theoretical framework for looking at capital spending in the public sector.



Policy implications of this model

The model depicted in the graphic and the idea that it is the stock of capital that is the input into the delivery of public services rather than the capital budget, have significant policy implications.

First, it suggests that the stock of capital must be maintained at a constant level to deliver the same or a higher level of services than a year ago.

Second, it suggests that the stock of capital changes gradually over time. Not maintaining the stock of capital results in its gradual deterioration while spending on new stock only adds gradually over a long period of time. Any additions to the stock through spending therefore are always reduced by depreciation. This second

implication is one of the theoretical reasons for the inherent bias against capital spending. Short-sighted managers can shirk on the maintenance of assets or stop adding to the asset base for a while before the service is affected. It takes a long time to expand the stock of capital. Some amount of capital spending is required just to maintain the asset base. This spending can be referred to as a capital baseline, in other words the minimum amount of capital spending required to maintain the existing stock and deliver a steady level of services. In practice, determining such a baseline is not a straightforward issue.

Third, it suggests that public services are delivered by some combination of recurrent spending and stock of capital. Public services can be improved by increasing either category. A system or service can have too much capital. It is no use having great school buildings when you do not have good teachers. The capital stock matters but recurrent spending also matters.

Lag between expenditure and actual delivery of the output

In the delivery of public services, there is a lag between when a rand or dollar is spent and when the output is delivered. If I hire a teacher today, I get some teaching in the classroom almost immediately. If I order some text books, I usually get some books delivered to a school in a few weeks or months time. If I decide to build a school, I generally get a school with children using the school in about two years' time. A major highway upgrade takes about three or four years. If I admit more teachers to universities, I get more teachers in about four or five years' time. If I decide to build a power plant, I get power in about seven to ten years' time. Similarly, if I cease maintaining a school, the negative impact is only visible in five to seven years' time. If I stop training teachers, the negative impact on schooling is not immediate, but gradual over several years.

This lag between spending and output is another theoretical reason that explains why the public sector is more likely to hire a teacher than spend money training teachers and is more likely to build schools than power plants.

Public finance theory suggests that managers are more likely to spend when the output is visible sooner than later. Similarly, when a manager faces a budget crunch, the first thing she/he does is to reduce maintenance, since no one would notice for at least a few years. A manager is more likely to give in to higher pay for teachers than to spend on building schools or replacing equipment in the science laboratory.

Many budgeting systems try to prevent or counter this inherent bias against capital spending. The ways in which countries achieve this ranges from having an entirely separate capital budgeting system to having a separate envelope for capital (see Box 4.2.1 for a discussion of such a system). Some countries that have fiscal rules that prevent the country from borrowing for recurrent spending, protect capital budgets

over the business cycle by not linking them to recurrent revenues.

This lag factor also means that a budgeting system has to go beyond protecting maintenance and capital spending. It also has to ensure that spending on power plants or highway systems is prioritised because the bias against taking such decisions is indeed strong.

Box 4.2.1: Capital budgeting in Botswana

The government of Botswana has over years used the national development plan (NDP) as a guide to achieve the national goals or objectives in the context of limited resources. The plan is prepared every six years and the current plan is NDP 9, which runs from 1 April 2003 to 31 March 2009. The plan was based on the principles of rapid economic growth, social justice, economic independence and sustainable development. The plan had a mid-term review in 2007 to review progress. All government ministries and civil society are involved in the preparation of this master plan. Ministries submit sector chapters (sectoral strategies) and development projects with total estimated cost and thumbnail sketches together with a clearly phased implementation plan. The NDP is the master plan from which all annual capital plans and budgets are prepared, and it is approved by parliament.

Budgeting process

Budgeting for capital projects is done on an annual basis. The Ministry of Finance and Development Planning co-ordinates the exercise. Allocations are made to ministries within an overall capital ceiling, which is determined by dividing total affordable spending between recurrent and development spending. Overall, the ministry considers capital spending next to recurrent spending, and ensures that the recurrent costs of capital spending are accounted for in the recurrent budget.

The process begins by ministries submitting projects to be undertaken in the coming year. As a rule only projects that are in the NDP are allowed to be included in ministries' submissions. Ministries' capital spending submissions consist of two parts: ongoing projects that have been funded in the past and new projects that will start during the new financial year. In preparation for the submission, an appraisal of ongoing projects is performed at ministry level to determine progress made and how much should be budgeted for the project in the new year. At the same time project plans and budgets are prepared for start-up projects. These budgets and plans have to use the thumbnail sketches, implementation plan and total estimated cost figures from the NDP.

At the central level the finance and planning ministry makes a revenue forecast for capital spending, which includes the revenue from own sources that can be used for capital spending and revenue from borrowings and aid assistance, preparing the ground for line ministries to submit their bids. The finance and planning ministry then uses the initial bids to prepare ceilings for individual ministries. These ceilings are communicated to line ministries, which use them to prepare a revised bid for discussion.

After the submission of the revised bids, the finance and planning ministry consults with line ministries through its project review committee. Ministries are expected to show the committee how they have prioritised their projects. These consultations are used to iron out ministries' bids to fit into the budget ceilings. A basic rule is that ministries should consider ongoing projects first before adding new projects to fit within the ceiling. The project review committee also uses the opportunity to review a ministry's project spending in the current year. Often there are funds that have remained unspent and which need to be shifted to other projects.

If at this stage there are projects that require additional funds over what has been allocated within the ceiling, these are referred to the Estimates Committee, which decides whether to fund the additional requirements or not. The committee is a constitutional body charged with vetting all projects and recurrent spending and finalising the development and recurrent budgets for the next year. Once the committee has completed its work, the development budget is presented to cabinet for discussion and approval. The final step is submission to and approval in the national assembly.

Project selection

Projects are vetted for inclusion in the annual budget according to whether they have been listed in the NDP and whether they are in line with national development policy. Feasibility studies are also undertaken to determine the viability of some projects prior to implementation. The appraisal of these projects sometimes includes thorough cost benefit analysis, particularly for major projects, to ensure that projects will generate an economic or social return for the nation over the long run.

Most capital projects implemented have a social benefit objective – generally involving necessary infrastructure development and provision of social services. These projects are not subjected to feasibility studies. Feasibility studies, comprising financial and economic analyses, are carried out only for commercially motivated and/or direct productive activities. As from 1994, all projects of this nature to be undertaken will be approved only if their estimated internal rate of return (IRR) is between 8 percent and 12 percent. Recently the Zambezi agro commercial project – a mega-project – was approved on account of an IRR of 18.8 percent.

Executing the development budget

After approval of the budget, line ministries are expected to prepare project memos on approved projects to commit their development funds to specific projects. Once the finance and development ministry has approved the project memos, a finance warrant in terms of which the funds are released is issued. This warrant equals the projected spending for the year and is valid for the year. It lapses at the end of the financial year. The development budget can, however, be adjusted during the spending year. Supplementary budgets are prepared three times a year to cater for budget adjustments, including adjusting the total estimates costs of approved projects or to move funds from one project to another. The adjustments may also include emergency projects, such as projects to address outbreaks of foot and mouth disease.

Conclusion

The method of handling the capital budget has served Botswana well so far. The discipline of a widely discussed and well-prepared NDP has minimised political incentives to insert projects unpredictably into the capital budget. A drawback, however, is that the method is not sensitive to changing requirements over time. While a mid-term review is carried out, it only comes after three years and does not allow the flexibility to respond to needs that arise annually. This results in projects being implemented that are no longer a priority, or priority projects that cannot be undertaken. It may be necessary to adjust the system to have more frequent reviews of the plan.

Source: Contributed by Moeti P Ekenyane, Ministry of Finance and Development Planning, Botswana

Inherent biases in different accounting systems

The nature of the accounting system followed in CABRI countries exacerbates these biases, particularly when there is pressure on countries to reach or maintain a specific deficit level. In a cash or modified cash accounting system all of capital spending is accounted for up front as the asset is purchased or built, and therefore adds to spending and by implication the deficit. Countries under fiscal pressure therefore often 'borrow' from their public asset base to maintain recurrent spending. The consumption of the asset of course takes place over many years. In an accrual accounting system the cost of the asset is only accounted for when it is consumed. Experience in an accrual system therefore has shown an opposite bias: because capital spending can be undertaken without affecting the deficit and capital spending attracts political support, accrual systems tend to spend too much on capital compared to recurrent spending, affecting the quality of public services and a country's deficit and ability to repay debt over the long term.

Distribution of public assets key for distribution of public services

The last, more obvious point required to complete this section is that the distribution of public assets is a key determinant of the distribution of public services. If there are no water pipes in poor rural areas, it is not possible to provide clean piped water. If there are no schools, the chances of schooling are remote (but not impossible). In many countries, the distribution of capital stock and the concomitant services is both a function of and sometimes reinforces inequality in society.

Generally, richer areas have a larger stock of schools, health facilities, roads and other network infrastructure. One of the key public finance problems in developing countries is how to balance the need to maintain what is sometimes expensive infrastructure in richer areas with the need to expand services in poor areas by rolling out new infrastructure. It is true that public officials prefer to cut the ribbons on new schools built than to spend money on maintaining existing infrastructure. There is no ideal answer to this question and each country must look at its own political economy to answer this question. Nevertheless, failure to maintain infrastructure is costly. The cost of rebuilding something in a few years' time is always more costly than to adequately maintain the infrastructure today.

Summary

To summarise, the fairly simple and obvious lessons from economic and public finance theory are as follows:

- The stock of capital is an input into the quality, availability and distribution of public services.

- The stock of capital changes slowly over time.
- There is an inherent bias against capital spending – particularly in cash and modified cash accounting systems – and this needs to be countered somehow.
- Higher capital spending can be used to improve the distribution of public services, but only if matched with the required recurrent spending.
- Maintenance is essential to sustain the level of public services and to save money in future.

4.2.3 Some conceptual and policy issues in relation to capital budgeting

Is there an optimal level of public sector capital spending?

This question can be tackled from two perspectives. First, is there an appropriate level of public sector investment? In an economy, investment roughly equals savings. Typically, in developing countries, investment exceeds domestic savings with the difference financed by importing foreign savings. This is an appropriate strategy provided that the investments are efficient and will enable the country to repay the debt over time.

There is no theoretical or empirical basis for determining the optimal level of public sector capital expenditure. A more important question perhaps, and this is the second perspective, is what would be an appropriate increase in any budget period? Against this question there are a few criteria or factors that should be considered. First, any sharp increases or decreases in public sector capital spending can have negative consequences. If the additional capital spending is financed by domestic borrowings, in the short term it might crowd out private sector investment. Second, any sharp increase in capital spending is likely to place strain on the capacity of the public sector to deliver sensibly. Public sector managers will always be more optimistic about their capabilities to roll out capital than what they should be, given the reality. Underspending on capital is a typical feature of countries in the early stages of an increase in capital spending. Third, if private sector capacity to deliver is weak or constrained, a sharp increase in capital spending will result in price increases for both public and private investments and will have the effect of crowding out private investment. Finally, capital investment is often import-intensive and a sharp increase in capital spending could put pressure on the balance of payments in the short term.

Similarly, sharp decreases in capital spending damage capacity within the public sector, which negatively affects the state of the capital stock and will lead to job losses in the capital goods sectors of the economy.

In general, steady and realistic increases in capital budgets are likely to lead to positive outcomes.

How does one deal with optimism bias?

Optimism bias refers to the phenomenon where departments or agencies underestimate the costs of the project during the budget-making phase. This improves their chances of securing funds. Once the project is under way, costs gradually rise and government has two choices – to stop the project or to provide that little bit extra to complete the project. Governments almost always provide the extra amounts to complete the projects. For large projects, cost overruns could amount to a significant proportion of the original cost estimate.

There are three things that central budget authorities or line departments can do in this regard. First, departments should be forced to absorb as much of the additional costs as is possible, even if this means postponing other projects or reducing the number of future projects planned. Punish departments who come to ask for more money to set an example. Second, treasuries can ask for an independent cost estimate from a third party surveyor. This is useful for large projects with high risks. Project plans for large projects should have contingencies built into them and the risks must be stated explicitly. The budget of a department must be tested for these tolerances before a large project can go ahead. Third, smart contracting can limit the impact of price increases and can transfer at least some of the risk to the private contractor. For example, capped or fixed contract management fees could help prevent or mitigate price increases through reducing the incentive of the project managers to inflate prices.

How much should be spent on maintenance?

There is no precise answer to this question. Figures range from 3 to 10 percent of the replacement value of the asset. The amount of maintenance spending is a function of two factors: the original design specifications and the utilisation rate. For example, if a road is built with the intention of lasting 30 years and taking 10 000 vehicles a day, then the amount of maintenance will depend on the age of the road and the volumes that it presently carries. The same principle applies to a school. The level of utilisation together with the original design specifications will determine the amount of maintenance required.

In practice, this method is not easy to follow as public sector managers never seem to have the original design specifications at hand. Also, determining replacement costs is not straightforward and needs to be updated relatively frequently.

Nevertheless, it is worth pointing out that routine maintenance saves money and delays the need for major repairs. Planned upgrades or renovations done on time limit the need for facilities to be demolished and rebuilt.

How does a country figure out the stock of capital?

Conceptually, let us assume that we are able to figure out what the size or value is of a country's or even a department's capital stock. This figure would then give us some basis to figure out what the baseline capital budget should be – that is the level of capital spending required to keep the state of the stock at the same level in terms of service delivery as in the previous year. Any additional spending is an increase in the capital stock and should result in better or more public services.

In practice, it is difficult to value the public estate. Valuation methodologies and their application differ widely. For example, a particular methodology may be appropriate for the defence sector, but not for health.

Having said this, there is merit in trying to assess the state of the stock. South Africa's best example is the schools register of needs, which counts the schools and itemises how many have electricity, water, toilets, ceilings and brick walls, and also gives a sense of whether the school infrastructure is good or poor. This enables much more effective planning in the education sector and therefore better use of resources. Other indicators such as a road defects index or simply the number of railway coaches in service are useful for getting a sense of the state of the stock and what is required to maintain or increase the size of the asset base.

Furthermore, assets differ in terms of their useful life. A building may last thirty years but an x-ray machine may only be useful for four or five years. Nevertheless, the same principles hold and asking questions about the age of the asset, the useful life of the asset and utilisation rate will give some indication of how much should be spent maintaining the asset base.

What role can public private partnerships play in delivering capital goods in the public sector?

In almost all countries, for almost all capital projects, the capital goods or facilities are provided by the private sector. That is, they are actually built by the private sector. Rarely does government itself own construction companies or have the capacity to deploy its staff to build roads or schools. Sometimes, governments employ work gangs to repair roads or to maintain facilities, but almost never to construct them.

Apart from using the private sector to construct infrastructure, governments can also leverage off the private sector through more formal long-term agreements. These agreements are known as public-private partnerships (PPPs). PPPs are long-term contracts between the public and private sector designed to improve service delivery and provide value for money. These arrangements allow governments to deliver infrastructure by leveraging off private sector expertise and innovation.

PPP structures come in many different forms, where the private party designs,

builds, operates and then transfers infrastructure back to government. The benefits of PPPs are that they can improve service delivery and strengthen the planning process (thus ensuring that both capital and maintenance are fully funded over the long term).

The theory is that if the same company or contractor that is responsible for building the facility is also responsible for maintaining the asset, then the quality of construction is better. Furthermore, well-structured PPPs can transfer at least some of the risk for cost and time overruns since they are only paid for services once the building is complete and being used.

Although such arrangements can be beneficial, they can come at a cost. In projects that have substantial risks, the financing and transactions costs can be substantial. There can also be increased fiscal risk by attaching long-term fiscal liabilities to government's balance sheet. Managing complex contracts can yield large benefits but also requires good capacity inside government. In places where this capacity is lacking, the private sector is not likely to take on the risk or is likely to make it very expensive to do so.

How does a country avoid boom–bust periods in its infrastructure sector?

Boom periods should provide governments with additional revenue, thus allowing them to increase expenditure on capital goods. The incentive to increase expenditure may also be present, as a boom can result in accelerating pressures on the existing capital stock while simultaneously creating new demands for new infrastructure, such as housing and electricity. However, as mentioned before, sharp increases in spending are not advisable. One reason for this is that the cost of capital goods will be driven up, thus leading to price pressures. It therefore makes sense to defer some investment expenditure until the construction boom has subsided. By deferring some capital expenditure the construction cycle is smoothed and investments provide better value for money. This is also useful if one is experiencing constraints in the sector, such as skills shortages, as this provides a longer period over which these issues can be dealt with.

From a fiscal sustainability viewpoint, it may be prudent to adopt some form of fiscal rule such as a current balance rule. This means that current expenditure is not funded through borrowing. This allows governments to borrow for capital even if revenues decline during a recession. However, even if capital expenditure is funded through debt, one needs to make sure that future returns on investments are sufficient to offset debt service costs.

4.2.4 How capital budgeting works in South Africa

Many of these problems exist in South Africa: some are mitigated by the country's approach to capital budgeting while others are exacerbated. Key features of the South African system are that it has a single budget and single budget process for capital and recurrent budgeting, and that planning for capital spending is decentralised.

Overall differences between centralised and decentralised budgeting systems

Systems in different countries differ in respect of where the decision to invest in the building of something is taken. In some countries, the finance ministry is presented with lists of potential capital projects and it determines which project is approved and included in the budget. In other systems, block allocations are made for capital to a department where managers and their political leaders decide which project is approved. In other countries departments themselves decide within a global allocation, how much will be used to maintain and add to their capital stock and how much for the recurrent cost of service delivery.

In general, centralised capital budgeting systems are said to be more efficient in that only higher value for money projects are approved. Assume for example, that all capital projects cost one dollar and that it was possible to rank all the projects by their benefit to cost ratio. And assume that there are one hundred projects on the table. If we have 20 dollars available, we simply approve the top 20 projects. This system is said to be more efficient because only projects with higher benefits are approved. However, it might be that all the good quality projects are defence projects or perhaps transport projects and that education and health projects are excluded.

A more decentralised budgeting systems allows government to say that we want x to be spent on health facilities and y on road projects. Within these envelopes, it is hoped that higher value for money projects will be prioritised. Therefore, a decentralised system may be less efficient (because it creates less value for money) but it is more likely to be effective, since it targets the value better.

Features of South Africa's decentralised budget system

With the exception of certain large projects, South Africa has a decentralised capital budget system where decisions on how much funds to set aside for capital stock replenishment and development and which project to execute, are taken by line departments and not the centre.

While this system has many other benefits in addition to a greater potential for effective investment in capital stock – such as better integration between capital and recurrent at the departmental level, the availability of specialised sector level information, knowledge and skills when capital spending decisions are taken, and

lower risk of a large number of unfinished projects¹ – it also carries significant risks.

One risk is that in aggregate government may not be investing sufficient funds in capital stock, affecting over the longer term its level of service delivery and risking a deteriorating environment for private sector growth. Another risk is that departments may not have good appraisal capacity and processes and may therefore not properly assess the cost and benefits of projects. The larger the project, the larger is the risk. This may lead to cost overruns or to negative returns on investment over time. Also, as discussed above, decentralised systems run a much higher risk of departments playing budget games by underestimating the cost of projects during planning in order to get them approved. Finally, the combination of decentralised decision-making and a single budget means that departments develop an expectation that their capital spending baseline should be conceptualised and treated in a similar way as recurrent spending baselines. When projects end they therefore expect the allocation to continue for use on other projects. Conceptually, however, a capital spending baseline is merely the cost of maintaining existing stock. To that baseline should be added only the projects which are necessary, given objectives and the long-term availability of recurrent funds to utilise and maintain the capital stock.

Risk mitigation in South Africa's decentralised system

South Africa addresses these risks in a number of ways. Despite having a decentralised system, it does have a capital budget team that works at the central level. A key function of this team is to appraise very large projects for which line departments present proposals to the Treasury. The proposals are assessed in terms of costs and benefits, value for money, capacity of the department and quality of the plans. If the project is supported by the Treasury, this recommendation is taken to the Ministers' Committee on the Budget (Mincombud – a cabinet subcommittee) and is then included in the department's allocation approved in the next appropriation bill. In the South African context, projects that are in excess of ZAR1.2 billion (US\$150 million) are considered mega-projects and go through this procedure. In total, a relatively small part of the total capital budget comprises mega-projects. There are also risks to having such a team: a key one is that the tendency to make trade-offs between mega-projects rather than between these projects and other types of spending within a sector may undermine the strategic benefit that comes with sector-level capital budget planning processes.

Another risk-mitigation measure operates in the budget scrutiny and challenge process that take place annually. In most cases, departments have ongoing capital programmes. The budget discussion that takes place between the department and the Treasury is about the magnitude of the capital budget for these departments

and about whether and by how much this should change, taking into account the condition of capital stock, future demand for services and other factors. In arguing for more money for health facilities or for police stations, line departments may in addition be asked to present information on specific projects and costs. However, which hospital is built or which police station is renovated is a decision of the relevant department.

Central scrutiny of key capital spending departments

In South Africa the bulk of the capital spending occurs in departments like water affairs, health, education, transport, police and housing. This means that the Treasury teams that work with these departments keep a close eye on the size and utilisation of capital spending, more so than for other departments with less dependence on capital stock. Budget discussions are generally about how fast these capital programmes are growing, the balance of spending on new building relative to maintenance, the quality of the infrastructure, value for money, and so on.

In South Africa therefore there is not a separate capital budget or separate process. Steps to counter the bias against capital are therefore taken implicitly rather than explicitly. The Treasury is mindful of both the value of capital in the delivery of public services and of the bias against capital spending by departments. For these reasons, it is likely to have a specific discussion with a spending department on its capital programme. When the Treasury makes its recommendations to cabinet through Mincombud, it takes specific cognisance of the bias against capital.

It is also true that when there is more fiscal space, allocations for capital are probably more generous than when budgets are tight. During the period of fiscal consolidation in the late 1990s when government was determined to reduce the budget deficit, maintenance and capital spending fell as departments could more easily cut these items than dismiss teachers or ground police vehicles (see discussion above about how the bias works in cash or modified cash accounting systems like in South Africa). While this may be an entirely logical response to fiscal stress, the cost of rebuilding the capacity of capital stock is much higher than what the cost for timely maintenance would have been, and it also takes time. This should manifest in significantly higher proportions of the budget being classified as capital spending. In the period after 2001, as fiscal credibility has been regained – with debt interest costs on a downward trajectory and the revenue displaying great buoyancy – the proportion of spending on capital stock has increased rapidly.

If decisions on which school or police station to build are taken at a departmental level, the Treasury has to be sure that the decision-making processes within departments are sound and robust. Another important function of the capital

budgeting team in the Treasury is to look at the capacity inside departments, review their techniques for assessing projects and their ability to deliver on capital projects on budget and on time. The task of the Treasury is seen as gradually raising the bar on capacity within departments. This includes checking whether they have the capacity to use cost benefit analysis tools and whether they have explored multiple options for delivering on the intended output, or different outputs to achieve an objective.

The intergovernmental fiscal system

To complete the picture of South Africa's capital budgeting system, one needs to provide a brief snap-shot of the country's intergovernmental fiscal system. Many functions – particularly social and household services – are delivered by provincial or municipal governments. Provinces raise almost all of the resources from central government while municipalities raise the bulk of the revenue on their own. Central government funds infrastructure at both provincial and local government through conditional grants that are earmarked for infrastructure in general, as well as through specific conditional grants that are more specifically earmarked, such as for hospital revitalisation. In addition, provincial and local governments spend a proportion of their unconditional 'equitable share' transfer on capital stock, as determined by their internal budget processes. Thus the sum total of capital spending at provincial and municipal level exceeds targeted infrastructure grants.

In the case of general infrastructure grants, provinces and municipalities are obliged to spend the money on infrastructure, but are free to spend it as they choose, depending on their own priorities, whether on roads, schools or public transport initiatives, and so on. As mentioned above, there are also specific conditional grants which specify the purpose of the allocation.

4.2.5 Conclusion

This paper looked at key differences between capital and recurrent spending that necessitate them being treated differently in budgeting. It then looked at capital budgeting policy issues. In the final section it provided a brief overview of the South African system, noting how it addresses some of these policy issues through its budget process and structures. In conclusion it is worth noting two capital budgeting policy areas that are not yet addressed adequately, but for which reforms are either in process or being considered.

The first is creating the capacity in the classification system to tag spending not only as capital and by programme and subprogramme and budget holder, but also to tag it by specific project. This would allow better monitoring of spending by departments,

cluster structures and the Treasury – particularly for cross-department projects – and more accuracy in assessing capital baseline when projects end.

The second is building the capacity to plan for capital spending projects ‘from cradle to grave’. This capacity refers not only to the project planning and management capacity, but also to create mechanisms within the medium-term expenditure framework system for spending with a longer-term spending horizon. Ideally, capital projects should work with two, five or seven-year funding predictability, rather than three.

4.3 Namibia: Managing ceilings by managing performance

Chris Claassen & Ruth Mukono

4.3.1 Introduction

Today, 17 years after independence, Namibia looks back on a track record of stable economic development and sound macroeconomic policies. Since 1996, government has been undertaking a series of public finance management reforms to further improve its performance. While initial reforms were primarily aimed at securing optimal fiscal positions, later reforms targeted the system by which available resources are distributed with a view to improving the quality of spending for better service delivery.

The idea was to use government's expenditure strategy as a tool to achieve clearly defined objectives. In Namibia's reformed programmatic approach to budgeting, expenses are justified according to the impact they have on outcomes. These reforms are in line with government's efforts to make pre-emptive and forward-looking policies for strengthened economic and social development, rather than policies that are reactive to crises and instability.

This paper describes how – within the context of the overall system – the Namibian Ministry of Finance uses budget instructions and its role in the budget allocation system to encourage spending agencies to take a medium-term view in prioritising objectives and choosing optimal input mixes to achieve performance targets. It provides a sketch of the past, followed by a description of the programmatic results-orientated reforms against the overall fiscal and budget reform process. The core of the paper, however, is the subsequent discussion of the rules set by and requirements of the budget guidelines, the criteria used to interrogate budget submissions and the use of budget hearings and budget ceilings. Finally, the paper looks at the way forward.

4.3.2 The old system

Before 1996, the budget was prepared annually with a one-year horizon.² Based on a macroeconomic framework drafted by the Ministry of Finance, the Bank of Namibia and the National Planning Commission, line ministries were asked to submit requests for funds. As the funds requested usually exceeded the total budget, an analytical process would have been necessary to finalise the budget and decide on allocations. But as this process was not in place, expenditures were made to fit the resource envelope by allocating incremental increases to each ministry and cutting their proposed expenditure accordingly.

The requested funds from line ministries were based on a line item budget system, where line items corresponded to expenditure items such as salaries and estimated expenses for vehicles, telephones, supplies and others. Spending was not justified on the grounds of policies and expenditure increases were derived by increasing the line items without looking at how the inputs would be used. The increases in expenditure did not rely on any long-term strategic financial planning nor were analytical models used to derive projections of the forward cost of current activities. Instead, expenditure was simply estimated from an accounting perspective.

During the spending year, line item budgeting also implied that ministries were not allowed to switch from one expenditure item to another without approval from the Treasury. This restriction removed any savings incentives once the budget was allocated to a certain item. This meant that ministries' hands were tied and they could not make optional decisions on the use of resources to achieve objectives.

4.3.3 The reform process

Since independence, the Namibian government has been going through a period of budget reforms aimed at enhancing accountability, transparency and management of public finances. In 1996, cabinet directed the prime minister's office, a small unit

within the cabinet secretariat, to lead reforms.

In 1999, the prime minister's office identified performance measurement in budgeting as a major weakness to address, and started to develop the performance and effectiveness management programme (PEMP), which is a structured way of measuring the performance of ministries. This was adopted by the Ministry of Finance, as the co-ordinator of the public financial management systems, and the National Planning Commission.

In 2000, a three-year rolling budget was developed. Under this budget, a medium-term fiscal policy view informed the overall expenditure envelope within which line ministries could plan for their expenditure and estimate the expected revenue for three years ahead. In 2001, the first medium-term expenditure framework (MTEF), including the first stage implementation of the PEMP, was published and it established the future direction of the MTEF process.

In 2002, the PEMP frameworks were completed and the medium-term plans (MTPs) were piloted in four ministries, and in 2003 they were rolled out to all line ministries. (See Box 4.3.1 for a summary of the MTP template). As part of the regular process, a final version of this document, adjusted to fit actual allocations by the ministry, is later tabled in parliament for each ministry as part of the MTEF book. This is in addition to the standard Estimates of Expenditure, the annual budget which parliament approves.

Box 4.3.1: Outline of a medium-term plan

MTPs are structured around nine sections:

1. Ministries are required to list their objectives (a limited number) and set out their targets in line with the objectives. The objectives must be specific, measurable, attainable, realistic and time bound; this means that they will be translatable into clear targets.
2. The MTP sets out ministerial revenue from the state revenue fund. In this section the ceiling amount is reported in three different lines: the operational budget ceiling; the development budget ceiling; and the development partners' amounts channelled through state revenue fund. This provides an overall spending ceiling for the ministry. The data should be provided for the two years prior to the current spending year, the spending year, the budget year and the two outer projection years.
3. Ministries must set out their priorities for the MTEF period. These priorities should equally be set out in terms that are specific, measurable, attainable, realistic and time bound, and which are subsets of the overall objectives. The priorities set out here must be already funded.

4. Ministries must present their proposals for distributing funds within their ceilings between their programmes in table format. The information for the three years of the medium term is framed against actual spending information for the previous three years. Ceilings for the first two years of the medium term roll over from previous allocations. Ministries are required to use their existing ceiling for the new second year, minus once-off allocations in that year plus a standard percentage, determined by the Ministry of Finance in line with inflation.
5. Ministries are required to give a brief explanation of each programme and list all activities to be carried out under a specific programme and attach a cost to each activity. The expected outcome has to be indicated under each programme, for the public to see the value for money.
6. Ministries must justify why they switched funds between programmes within their overall ceiling, compared to the previous year's final MTP. While ministries can switch funds prior to the budget year, they are not allowed to switch between programmes during a financial year. Then they may only switch between activities within a programme.
7. Ministries are given an opportunity to request additional funds, but governed by the rules set out in the main body of this paper. Additional requests for the final year should also be indicated here. All requests must be accompanied by an explanation of the results that will be achieved.
8. Ministries are required to set out the funds received by development partners in addition to the funds allocated through the state revenue funds. Ministries must complete two tables for each of the six years (two backward looking, one present and three forward looking) covered in the MTP: the first one by development partner or basket fund, and the second by how the funds are distributed among its programmes. The funds and their distribution must be justified in terms of the ministry's priorities, which is covered in the final section.
9. In the final section of the MTP, ministries are required to report on the parastatals and off-budget funds under their jurisdiction. For the parastatals, ministries need to provide their profit and loss or income and expenditure accounts and their balance sheets, together with a report on their return on assets and a report on the auditor's opinion on their most recent financial year's statements. For off-budget funds, ministries must report on funds over the six years covered by the MTP and provide the balance at the start of the year, the receipts and expenditures for the year and the closing balance at the end of the financial year.

Line ministries also attach performance indicators as attachments to the medium term plans. All this information is vital to the budget officials as it helps with the analysis of the budgets of the line ministries.

In 2005, for the first time in Namibia, the Minister of Finance tabled the MTEF document in parliament as the official document to be used by parliamentarians when debating the budget. This was to replace the line item book that they had been used to. Fiscal rules and ministerial targets were also introduced at this time.

4.3.4 Developing a medium-term results framework

The budgeting system in Namibia is a top-down process in terms of resource allocation and bottom-up in terms of the selection of priorities, programmes and main activities for the financial years. The fiscal year is from 1 April to 31 March. The Ministry of Finance imposes a medium-term discipline on the budget process through (i) the rules on what can be requested and how it should be requested in budget submissions, (ii) scrutiny of budget proposals and (iii) rolling over baselines from the previous year as initial, but already firm, ceilings.

Guidelines for preparing budget submissions

Every year, towards the end of June, the Ministry of Finance issues guidelines to ministries to prepare their budget submissions. This signals the start of the new budget cycle. The guidelines are designed, first, to provide ministries with the opportunity to conduct due diligence on their existing approved MTP and second, to budget for any new priorities that they want to introduce.

Conducting due diligence includes the obligation to review their own reforms, the quality and status of their performance measures and their overall progress against their stated priorities and government's commitments. Ministries are therefore required to first plan for results, and not primarily by expected input costs. Once they have identified their desired results, cost would come into play, but would be allocated funds in line with priorities. In this process ministries identify areas of service delivery where their actual achievement falls short of the results they had indicated in their MTP submission to parliament the previous year they would achieve using the funds allocated to them. They are required to indicate what changes they deem necessary to deliver on their plan and achieve results.

Changes may include requests for changes to appropriations on the basis of identified spending pressures outside of the ministry's control. However, this is usually granted only in specific circumstances where the pressures cannot be managed without impacting on the quantum or quality of government service delivery in a national priority area or against a government commitment. In most circumstances, ministries are expected to develop strategies to manage the results within a ministry's multi-year expense limit.

A main focus for the guidelines is therefore to encourage ministries to deliver

results within the current multi-year/MTEF allocations, while clearly identifying and managing inevitable pressures and risks. The information provided by ministries in their submissions ensures that the Ministry of Finance is able to meet these requirements. From its side it also reviews activities to ensure government is investing in key priorities and is applying its scarce resources towards improving service delivery. How the ministry manages the budget process is critical in ensuring that a focus on results is carried through to all government ministries and agencies.

The guideline rule towards these ends is that ministries' allocations (expense limits or ceiling amounts) remain at the multi-year ceilings estimated during the previous year's MTEF process. It is only for the third year (or second outer year) that ministries are allowed to make additional requests for new priorities. This rule shifts the focus in the budget process to the future, leaving ministries with sufficient time to plan for new activities and do the legwork required to spend new funds well.

This means that all financial requirements for the first two years of the medium term must be accommodated within ministry expense limits, including provisions for salary award increases as well as other known factors. As in all countries, while this is the general long-term rule, specific spending issues crop up that can undermine the rule, unless they are managed up front. For example, currently in Namibia there is recognition that compensation and benefit costs are increasing, breaking previous trends. Ministries are therefore encouraged to clearly identify costs such as these which they manage within their plans.

In practice, ministries do submit additional requests outside the existing approved ceilings for the first two years of the medium term. When this occurs it is the task of the Ministry of Finance to ascertain what need there is for the funding. The ministry then requests ministries to indicate the marginal impact/expected outcome of the requested amount. Ministries are not allowed to justify the request in terms of costs or input requirements. Most ministries drop out at this point as they are unable to motivate their requests in terms of the expected results.

Criteria used for interrogating baselines and new requests

The Ministry of Finance scrutinises every budget submission. Its budget examiners are instructed to:

- Examine the objectives of the department to see whether they are in line with its functions and with the national development plan.
- Examine the stated departmental priorities and test them against the requirements that they should be specific, measurable, attainable, realistic and time-bound. This is how the Ministry of Finance ensures that the

performance information is concrete and that Parliament can hold the performance of ministries to account.

- Check whether there were virements during the previous year. If there were, the next step is to ascertain why funds were moved from one activity to another. If it transpires that funds were not needed for the activity for which they were originally allocated, the Ministry of Finance can decide not to continue the baseline allocation for the original activity.
- Check the detail of additional requests. If ministries submit without detailed breakdowns, the budget office requests additional information from ministries, including as explained above, the additional results the ministry is expecting to achieve with the additional funds. This usually reduces the number and magnitude of requests dramatically.
- Use past performance and performance indicators to challenge the budget submissions. For example, in 2005/06 the Ministry of Education requested an additional N\$2 million to buy textbooks and indicated that if the funds were allocated, the expected result would be a 1:1 learner textbook ratio in the following year. If the same request is repeated down the line, the budget office would use the performance indicator as a reference and challenge the request. It would then be up to the Ministry of Education to justify a new request, including reporting on its performance with the previous allocation.

The budget hearings

After consulting with line ministries and getting the additional information, the budget examiners in the budget office prepare a set of recommendations for internal use. The Ministry of Finance as a whole uses these reports to prepare for the budget hearings. The purpose of the budget hearings is for the Ministry of Finance to formally consult with line ministries on their requests for funds and for ministries to put forward arguments for sustained or additional funding, depending on the fiscal situation.

In its drive to frame future allocations in terms of past performance, the Ministry of Finance recently introduced accountability reports. (See Box 4.3.2 for description of accountability reports). These reports must be prepared by each ministry as part of the budget process. The reports provide actual expenditure information for the previous two years against budget, and actual performance information against targets.

Box 4.3.2: Outline of a medium-term plan

Following the ministerial targets which were introduced in 2006/07, the Namibian government has decided to move to a system of accountability reports based on ministerial targets. This will enable parliament and the public to evaluate the implementation of line ministries budgets and the extent to which line ministries are succeeding in meeting each of the ministerial targets that are recorded in the MTPs and which were also tabled in Parliament in 2006/07.

The accountability report covering 2006/07 contains the following:

- a summary setting out the overall performance of the ministry during the year
- a statement of actual expenditure by programme against budget, together with an explanation of variances
- for each ministerial target contained in the 2006 MTEF, the outturn for 2006/07, together with projections for the rest of that MTEF period. Each target is followed by an explanation of exactly what is being measured and how, is followed by a short commentary on trends and prospects
- ministries may, at their discretion, also report on performance against other key PEMP indicators, where they consider that that would aid parliament's understanding of their performance.

In addition to the above, line ministries are requested to report separately on the capital projects execution. Therefore they should list all capital projects for which funds were budgeted during 2006/07 (including projects from which funds were later vired and projects for which funding was not budgeted initially). An explanation is required for each variance between budgeted and actual expenditure. Line ministries also provide a breakdown of revenue collected against the original estimate, together with an explanation of any variances.

The accountability reports contribute to holding ministers responsible for the overall implementation of funds for their votes. The reports will hopefully become a focus for the media and make the programme budgeting reforms more effective by reporting on results against programme objectives, rather than whether inputs were used as planned. Until now the media has been confined to reporting on how much ministries get, but not on how much ministries achieve in terms of outcomes. The accountability reports will be published independently from other budget documents, not as an attachment or an annex, which will make them more visible.

The accountability reports, together with the feedback from budget examiners, allow the Ministry of Finance to make the budget hearing as much about past performance as about future plans. The accountability report helps with the analysis of line ministries' bids as it outlines the programme expenditures, collection of revenue, and the implementation of capital projects for the previous year. A significant part of the hearing is spent on examining past performance, which sets the tone for additional requests.

After the budget hearings – some ministries may be called back a few times to ensure that all information is on the table – the budget office makes recommendations to the Minister of Finance. The minister is then in a position to decide on his/her recommendations to cabinet with regard to adjustments to ministries' ceilings over the medium term. Once cabinet has decided the adjusted ceilings, these are communicated to the line ministries which then map their medium-term plans onto the detailed Ministry of Finance forms, or the submissions for printing into the Estimates of Expenditure, in time for tabling in parliament.

The role of ceilings in the process

The underlying rule is that the only ceiling that is not final at the start of the budget process is the new second outer year ceiling. For the rest, ministries are expected to make their own trade-offs and manage their own affairs in such a way that they remain within their ceilings allocated in previous budget years.

This is, however, not a rigid rule. In practice, budgets deal with a lot of uncertainty, so there needs to be some flexibility for adjustments. The uncertainty does not only concern the changing economic and financial contexts of budgets, but also new policy demands and changing spending environments. The Namibian process therefore allows for additional allocations on the margin of firm ceilings for the first two years of any budget submission. But the results-based nature of the process ensures that ministries have to put in significant planning and budgeting effort to show that they require the funds to achieve their objectives and that they are likely to use the funds well before they receive additional funds.

At the end of the strategic budget process (or the medium-term process) the changes in ceiling amounts mostly affect ministries that had requested additional allocations as well as those that are implementing new capital projects. But in most cases the communicated ceilings for the first two years stand. An indicative amount for the third year is determined by using the previous year's final allocation as a floor, minus once-off allocations, and adding an amount equal to expected inflation. If ministries request an additional amount over this derived ceiling, this amount needs to be justified in terms of sustained or additional results. These requests are examined with the same rigour as additional requests for the first two years. Of course, additional approved recurrent expenditure for year one and two would also be added to the final year three ceiling.

The Ministry of Finance is only responsible for the operational budget, but still sets the development ceiling total with fiscal rules, while the National Planning Commission is responsible for the allocation of the development budget. The split between the recurrent and development budgets within the fiscal rules is determined

up-front through consultation between the Ministry of Finance and the commission. Ministries receive their development budget ceilings over the three-year period from the commission and these ceilings are included in their medium-term plans. When the budget is tabled in parliament, the Minister of Finance takes overall ownership of it.

The ceiling amounts communicated to line ministries include the donor financing through the state revenue fund, but they are reported as additional to the votes on the budget. The donor funds paid through government's allocation are recorded together with the operational and development ceiling from government, but accounted for separately in the medium-term plans. Donor funds that flow to ministries outside of the state revenue fund are also reflected in the external financing table, but they are not included in issued ceilings.

4.3.5 The new budget process: Balancing discipline, predictability and flexibility

Many of the Namibian reforms have been about achieving discipline in the budget process. A primary objective was to improve fiscal discipline and ensure that the budget is sustainable in its entirety over the long term. Of importance here is how it affects the country's long-term debt situation.

At the second level and of equal importance have been efforts to instil planning discipline in spending ministries. Significant success has been noted at this level. One measure of this is that for the past four years ceilings were issued only once in the budget planning and expenditure execution cycle; this means that no supplementary budgets were tabled. When ceilings are issued, all aspects of expenditure are included.

Again, in order to deal with uncertainty, the budget includes an additional 1 percent of the total budget. This is voted on the Ministry of Finance vote and is there to accommodate crucial matters agreed on after the budget. There is also a further amount appropriated on the Ministry of Finance's vote, which serve as a contingency for the whole financial year. Specific rules govern the contingency fund to ensure that it provides for necessary flexibility, rather than undermines discipline. (See Box 4.3.3 for the rules governing the contingency funds).

Box 4.3.3: The contingency funds

Only important and unforeseen expenditure is paid from the contingency fund. This would include emergency expenditures. The Ministry of Finance does not transfer funds from this amount to other ministries. Instead, ministries have to put in detailed requests for additional funding while the Ministry of Finance handles the procurement, payments and reporting for funds used. The funds may also not be requested to cover personnel expenditure.

4.3.6 Conclusion

While much progress has been made in ensuring that ministries spend no more than what they are allowed, and that they spend on what they said they would, it will take some time for the recent reforms to enforce better planning and deeper accountability. For one, it requires ministries to have a much more integrated planning and budgeting process. It is no longer in the interest of ministries that their finance officers prepare budgets and allocate available funds based on the previous years spending by line item in isolation from the users of funds. A much more strategic process is required, where ministry leadership and programme managers get involved to make sure they balance the need to set programme-based targets in line with their funds with the need to allocate funds in line with their programme-based objectives and targets. This requires a different skill set for budgeting in addition to those required for the purely financial costing and estimating done previously, as well as much deeper involvement from non-financial officials and management. It also requires parliament, the media and the public to play their roles in making targets count as budget management tools. However, initial results are encouraging and are supported by the Ministry of Finance's complementary reforms in financial management systems and information.

4.4 Ghana: Process discipline and policy effectiveness drive the new budget process

Kwabena Adjei-Mensah

4.4.1 Introduction

Over the past ten years, the budget process in Ghana has undergone a series of reforms within the broader public financial reform framework. Some of the major changes include the change from line item budgeting (incremental) to a medium-term expenditure framework. There has thus been a shift to the development of medium-term sector plans which are aligned to and consistent with the national development plan. This shift has also meant a departure from:

- an annual perspective to a three-year perspective
- an incremental to a more analytical basis for resource allocation
- a broad-based budget to the inclusion of donor and internally generated funds.

One important outcome of the current process is that the budget allocations for the budget year provide the basis on which baseline allocations are projected for the two indicative outer years. In the case of Ghana, 'baseline' refers to the rolled over estimate of expenditure (or allocation) from the previous year's MTEF round. For example, for the budget year, the rolled over baseline macroeconomic targets, fiscal framework ceilings and ministries, departments and agencies (MDA) allocations of the previous year's first indicative outer year, become the basis for developing the final ceilings for the budget year. This facilitates stable levels of funding and a more predictable medium-term planning horizon for ministries. It also means that there is incentive in place for ministries to plan over the medium term: ministries that plan better over the medium term are assured that funding for their priorities will be in place by the time the budget year rolls around, leaving them not only with some space for further requests but also giving them more time to develop more detailed operational plans. This paper investigates how the process of ceiling setting operates, whether the current rules ensure sufficient take-up of these opportunities for forward planning, and if not, why not.

4.4.2 The budget process in Ghana

Ghana's budgeting system has continued to be a top-down process in terms of resource allocation, but bottom-up in terms of the selection of priority programmes at the sector level. Budget preparation within this system takes a full year, with preparation for the ensuing year starting in January of the current year; for example, preparation for the 2008 budget started in January 2007.

Interrogating the baseline and setting the framework

The setting of ceilings plays an important role in ensuring that sector trade-offs are made bottom-up at the sector level. In contrast with earlier practice, final ceilings are now not an outcome of the full budget preparation process, but operate instead as a midway milestone in the process. Once ceilings have been set, a further process ensues during which MDA spending allocations within the prescribed ceiling are set and examined carefully by the MDA to maximise policy effectiveness and for the Ministry of Finance and Economic Planning (MOFEP) to check on the effectiveness of operational efficiency through policy hearings and other mechanisms.

It is important to give some highlights on activities that take place *before* the ceilings are set and circulated to MDAs. The activities are critical to ensure a more strategic distribution of funds between MDAs.

Submitting memoranda

The MOFEP places advertisements in the national dailies, requesting the general public including civil society and private sector groups to submit memoranda as inputs into the budget under consideration. The submissions are sent to the budget development unit of the ministry. NGOs are relevant stakeholders insofar as they work in the public interest and in principle seek the welfare and development of the entire society. Corporate entities, on the other hand, drive the private sector, which is the growth engine of the economy. Both groups are therefore very important stakeholders in the development of the national budget. They may also contribute important insights towards better use of funds.

Updating the macroeconomic framework

An early top-down step in the budget process is the updating and projection of the macroeconomic framework, which sets the constraints within which further budget preparation is undertaken. The overall ceiling and distribution of government and donor resources are also updated.

Policy review

An early bottom-up step comprises a review by MDAs of their existing policies within the framework of the second generation growth and poverty reduction strategy (GPRS II) and other new and emerging government priorities. MDAs also assess their own broad expenditure requirement – in other words, the forward cost of their existing policies and activities – and identify gaps in funding and mismatches between requirements and their current rolled over distribution of funds. While the budget process provides the necessary instruments for departments to undertake this vital step towards an increasingly realistic set of budget year allocations and better forward planning, take-up of the opportunity has differed among MDAs. Some MDAs have had very detailed costed, sequenced and prioritised strategic plan documents. Others have not.

During the 1998 budget hearings – when it became critical that plans would be the basis for confirmation of ceilings provided and/or for further adjustment to be considered – many MDAs admitted that consultants were still working on their policy documents and strategic plans. This had been the situation before when strategic plans were not insisted upon or were not a pre-condition for resource allocation. The budget hearings gave the ministry the opportunity then to demonstrate its seriousness about the criteria for resource allocation.

Cross-sectoral meetings

The MOFEP and the National Development Planning Commission (NDPC) facilitate meetings among MDAs to enable them to present their priority areas in relation to the GPRS II and to take steps to jointly scrutinise their activities. The aim of these sessions is to agree on the national and sector goals for the broad sectors as well as the outcomes within the broad sectors. In the meetings MDAs discuss:

- areas of overlap and duplication in outcomes, objectives and key outputs
- areas where cross-MDA collaboration and co-ordination are required in the planning and implementation of activities
- comments/feedback on prioritisation of objectives between MDAs within the same broad sector.

Review of sector ceilings

The MOFEP in the meantime undertakes a series of activities at the centre, which are aimed at informing the final ceiling allocations in terms of cross-cutting government issues. A first step is to update the macroeconomic framework to determine changes in the overall level of resources. Second, a national policy review process is undertaken to determine changes in direction. Work at the technical level is done by the MOFEP, which then supports discussions in the cabinet sub-committee on finance. Finally, the MOFEP also undertakes technical work on cross-cutting financing issues in government. The final ceilings issued to MDAs in this regard comprise a forecast for:

- Services expenses, based on the priorities of the MDAs. Services expenses refer to the cost of operational activities that the MDAs undertake to deliver services. This may include, for example, travel, workshops or consultants' fees. Preference is given to MDAs whose core activities are critical to delivery in terms of the GPRS II.
- Investment, based on national priorities from the GPRS II. Investment is an important vehicle through which government operationalises the GPRS II. Therefore, the investment allocations are strongly skewed towards the GPRS II delivery sectors. MDA priorities on account of their mandates are, however, also taken into account.
- Personnel emoluments and administrative expenses, based on MDA costing and an analysis across government. While human resource planning is an important operational requirement for ministries, government must also adhere to or work towards personnel spending targets as a percentage

of GDP and as a percentage of total revenue raised. Ghana currently spends approximately 50 percent of domestic revenue raised on personnel emoluments, 15 percentage points higher than the convergence criteria for the common anglophone West Africa monetary zone. It is in view of these constraints that personnel spending ceilings are set for ministries separately.

The aggregate ceiling for the first year will be broken down into these four categories, listed above.

4.4.3 Allocating resources between sectors

Once MDAs have undergone their policy reviews, the MOFEP uses this information and its own technical preparations and the outcomes of discussion from the cabinet subcommittee on finance to review and update the three-year ceilings and prepare proposals on ceilings for cabinet consideration and approval. The ceilings cover a three-year period and provide for an integrated budget, which includes government funds, internally generated funds and donor funds across all four items. The aim is to encourage MDAs to consider all their resources together and allocate the resources available in line with their priorities. Once the preparatory work is completed, including the determination of total resource availability based on macroeconomic and fiscal policy considerations and revenue forecasts, the following factors are taken into account before deciding on the allocation between sectors:

- The relative priorities of the sectors in terms of government objectives.
- The role of government within the sector. (A changed role of government from producer to regulator will result in lower funding requirements. Thus even if a sector is a priority for government in terms of achieving its objectives, if the role of government is mainly to provide an effective regulatory framework, then the funding requirements for the sector will be lower than if the role of government was provider of services.)
- The funding requirements for each sector based on agreed objectives and targets, such as free basic education, as defined in the central and sector policy review processes.
- An investigation of alternative ways of achieving government objectives that would reduce the need for government funding.
- An assessment of available efficiency savings that would reduce the requirement for government funding.

Consideration is also given to the commitments of government from the previous year's budget.

The resulting proposals by the MOFEP are discussed by cabinet and final sector ceilings are issued in the budget guidelines.

4.4.4 Budget guidelines and scrutiny of intra-sector allocations

The budget guidelines are an important marker in the Ghana budget process. They signal that the top-down allocation of resources dimension is complete and that the focus now shifts to preparing sound financing proposals within sectors for MDAs' approved policy priorities. Another shift at this point is from a three-year strategic outlook, to an operational outlook of the first year of the budget. The guidelines provide the final ceilings, together with the framework for the budget. The guidelines also set out the criteria and logic behind allocations. For example, in the 2007 budget, funds had to be allocated for preparations for the Africa Cup of Nations soccer tournament. This was explained in the budget guidelines, together with an indication of other priority areas that did receive funding. Emphasis is placed on the immediate year figures (first year) while the two outer years only show indicative aggregate figures. Once the budget guidelines are issued, the following processes take place:

Policy hearings

The MOFEP/NDPC meet all MDAs to discuss the broad policy direction of each MDA. In the policy hearings all MDAs present their policies, strategic plan for the next three years and the outcomes of their policy reviews. They have to demonstrate convergence with national priorities, as articulated in the GPRS II. The MOFED sees each ministry, on a one-on-one basis. The emphasis of the hearings is the policies that will be funded within the provided ceilings and how these underlie the figures that are brought to the technical hearings. The policy hearings also provide the opportunity for the ministry to determine duplications in function and programmes within sectors and to develop measures to address them.

Technical hearings

The MOFEP, in collaboration with the NDPC, meet all MDAs to review their costed activities, objective, inputs and outputs within the strategic plans as presented during the policy hearings. This is to ensure that the final estimates fall within the approved ceilings. These meetings also afford the MOFEP a final opportunity to consider requests for top-ups for cabinet to consider.

In assessing the expenditure implications of policies, the following criteria are applied:

- Is information available on the expenditure implications of the policy? Does the ministry have projections on the cost implications over the three-year period? (With regards to this question the MOFEP now provides a list of standard cost items to improve the quality of costing and assist itself in assessing spending bids technically.)
- Is the policy affordable within the existing levels of resources provided to the MDA, from internal and external sources?
- Is there scope for cost-sharing (among entities from the same sector) in the existing policy?
- Is there scope for handing over the service delivery function to the private sector or communities?
- Is it a once-off event that will not recur over the medium-term period?

It is important to bear in mind that priorities do not always translate into higher levels of resources. High priority objectives may require lower levels of resources. For example, policy formulation may be the highest priority but may not require large resources. Service provision may be a lower priority, but require more resources.

Analysing allocations

Based on the above analysis, expenditure allocations within MDAs' ceilings are reviewed and any adjustments made to reflect both the priorities and the requirements *between* objectives, cost centres and the four items of expenditure.

If the allocations are to be changed from the allocations in the ceilings, the reasons for the changes are noted. For example, changes in the objectives and/or policies could drive allocation shifts, or changes in priorities and additional information on cost centre requirements that was not available at the time the ceilings were set and circulated.

If additional resources are required for the subsequent three years, MOFEP will have to consider:

- Which particular objective and/or policies require additional funds?
- What would be the implications of not providing the additional resources?
- Have alternative ways of achieving the objectives been considered that would require fewer resources?

As a rule there is not space during the policy or technical hearings to increase the ceilings that were allocated in the budget guidelines. However, in order to provide necessary flexibility, ceilings can increase but only under exceptional circumstances.

These usually should be unforeseen and unavoidable, such as the increase in allocations for purchasing more expensive crude oil when a combination of high international oil prices and the effect of drought on hydro-electric power schemes meant a shift to more expensive forms of power generation. Ceilings may also increase because of technical errors in earlier allocations. In short, increases are usually because of a change in the financing of a policy that had already been approved for inclusion in the budget and not on account of new policy proposals.

Dividing the MDA ceiling between the cost centres

Once the technical hearings are complete, it is the responsibility of the budget committee in MDAs to allocate the MDA ceiling between cost centres and objectives. For any one MDA this is the point where it is faced with three possible scenarios:

- The broad expenditure requirements are the same as the ceiling: In this case the task of the budget committee is to check the allocations between the cost centres and objectives. Are they still in line with the MDAs' priorities and requirements?
- The broad expenditure requirements are higher than the ceilings: The budget committee will then need to use the ranking of objectives and cost centres developed in the policy review to revisit cost centre expenditure requirements to fit within the ceilings.
- The broad expenditure requirements are lower than the ceilings: In this case the budget committees use the agreed priorities and information on priorities to allocate the additional resources to the priority cost centres and objectives.

Once the budget committee has agreed on the cost centre ceilings these are communicated to all centres as they start on their review and update of the strategic plan and estimates.

4.4.5 Remaining challenges

The reformed budget process has brought many advantages. There is a much stronger strategic element in setting priorities, and there is much more information available for decision-making and it is of much better quality. Roles and responsibilities are clearer and there is more discipline: it is now much more difficult for ministries to access funding outside of or late in the process. The strategic involvement of cabinet is important for the legitimacy of decision-making.

But, to what degree have the process rules helped ministries make better decisions

because they are planning within a more predictable framework of medium-term resources? Do they make use of this perspective to improve decision-making for the budget year and thus also the effectiveness of spending?

Need for MDAs to use the medium-term perspective more effectively

On balance, the reforms have empowered ministries to allocate available funds using their better understanding of their own sector. However, not all ministries have changed their approach to budgeting equally. A strategic focus is not always present: a number of MDAs spread their scope of work and objectives too widely instead of concentrating on their core mission, and request resources that are above the ceiling set by the MOFEP. For example, an MDA requested additional funds over its ceiling to undertake HIV/Aids education. This is despite the fact that specialist institutions exist that are already funded to undertake such activities.

Not all MDAs have shifted from an incremental approach to budgeting. Some do not realise that they do not necessarily have to be given ceilings that are over and above the previous year's allocation. When a one-off event causes allocation to increase for the short term, MDAs expect the funding to continue because they perceive it as part of their baseline. The policy and technical hearings offer the opportunity to settle such disputes or misunderstanding.

Not all MDAs use the new process to start early and undertake more thorough operational planning for budgeting purposes. They still treat it as an annual budget and prefer to wait until they have their ceilings from the budget guidelines before initiating internal planning processes. This means that they get caught during the spending year when their budget structure does not fit their needs. This happens because they do not perceive one MTEF rolling over into the next, but rather see them as a series of discrete sets of budget allocations. They therefore do not see the benefit of starting internal processes using existing baseline forward allocations as a guide. In order to address this problem, consideration is being given in the MOFEP not to provide a first set of adjusted indicative ceilings (adjusting the rolled over baseline 'in draft' on the basis of a strategic priority assessment and an update of the macro-economic framework), but rather to use the exact rolled over amounts.

Another way in which MDAs often fail to use the medium-term horizon well is in planning for capital projects. For example, when a huge capital project is undertaken like building a road, a hospital or a school, MDAs still request the full cost of the project in the first year even though the project may take more than a single year to complete. This is despite the availability of a medium-term budgeting instrument.

While the ceilings that are set after the technical hearings are supposed to be final, some ministries behave in ways that result in their total allocations increasing. For

example, donor grants and loans may require matching funds which were not made explicit in documentation or the budget process. However, since it is a contractual obligation, it ends up being funded in addition to the final ceiling. There is a need to adjust the budgeting rules so that the MDAs fund these expenditures from within their own ceilings.

The politics of the budget process

Finally, the politics of the budget process remain a stumbling block to spending effectiveness and efficiency. In principle, MDAs should allocate funds within their ceiling because they have better information about what is needed, but in practice there are other considerations that drive decisions. For example, the alignment between resource allocation to cost centres and MDA priorities may be weak when budget committees lack technical capacity or ‘independence’ within the ministry. For example, headquarters may allocate a substantial amount to itself for monitoring, while allocations to cost centres to undertake the activities in the districts are low.

4.4.6 Conclusion

In conclusion, the Ghana experience shows that while processes may be changed at a rapid pace, additional information requested year on year and rules be set, the system of funding policies will only become more efficient and effective if all role-players implement the prescribed processes evenly. This is the ongoing challenge of budget reform.

Endnote

1. Because departments face a trade-off within their ceilings between capital and recurrent, they are less likely to carry many unfinished projects with small allocations for long.
2. To be precise, the budget in Namibia is allocated votes and not every vote constitutes a ministry. However, for the purpose of this paper, the terms will be used interchangeably.

5

Bringing aid on budget

5.1 Introduction

CABRI, in collaboration with the Strategic Partnership for Africa (SPA),¹ commissioned a study of country practices to reflect and integrate aid on budget. The study researched issues and practices in ten CABRI countries and undertook a literature review of among others, donor practices. A Synthesis Paper and Good Practice Note were produced subsequently, aimed at better equipping aid recipient governments to lead the inclusion of aid on budget at country level. The paper (see 5.2), drafted on the basis of the research outputs by the Mokoro Limited team who undertook the study, provides a summary of the study design, findings and recommendations.

The study took the joint donor/government undertakings of the Paris Declaration as its point of departure. The research framework was therefore designed with the assumption that bringing aid on budget is not an end in itself, but should contribute to making aid more effective, optimising the management and use of countries' own resources and ultimately, to improved development outcomes. In this regard, it was clear from the outset of the study that an inclusive definition of aid on budget is required. The study therefore defined what 'aid on budget' would mean for each stage of the budget process and identified good practices to ensure its effective reflection and integration. A key finding of the study was that public finance

management and aid management should not be seen as separate areas of reform, but that they are intertwined, particularly in high aid-receiving countries. The study findings also cautioned against too strongly associating the bringing of aid on budget with creating favourable conditions for budget support, and against defining project support as off-budget. In most countries, project support still comprises a significant proportion of development support and in many the project portfolio has grown both in number and in size, even when budget support grows. While the study therefore emphasises progress against a public finance management reform agenda as a sound strategy to bring aid on budget for all aid modalities, it urges countries to also take the lead in establishing specific processes to bring project spending on budget. The study recommendations also emphasised the need for donors to remove central obstacles to putting aid on budget, align headquarter and country practice, and heed better the requirements at each country level to integrate their aid effectively throughout the budget cycle. The complete study outputs are available on the CABRI website at www.africa-sbo.org.

5.2 Good practices for bringing aid effectively into the budget system: A synopsis of the CABRI aid on budget study²

The Paris Declaration has put the use of government systems at the centre of the international aid effectiveness agenda. Several of its indicators relate directly or indirectly to 'putting aid on budget', which has thus gained prominence as a joint concern of governments and donors. Against this background, CABRI and the SPA commissioned a study of putting aid on budget. The aim of the study was to produce outputs that will better equip government in Sub-Saharan Africa to lead country-level processes to ensure that aid flows are properly reflected in national budget documents.

The core of the study was case studies of ten CABRI countries: Ghana, Mali, Mozambique, Rwanda, Uganda, Burkina Faso, Ethiopia, Kenya, South Africa and

Tanzania. The first five countries were studied in greater depth. In each country, researchers assembled the best available information from existing sources and focused especially on trying to explain the patterns of aid capture that were found. Drafts of the country findings were circulated to government and aid agency representatives for comment. The research was supported by a literature review, among others, of donor practices, which was published separately. All study documentation is available on the CABRI website.

This paper, a summary of the Good Practice Note and Synthesis Report of the study, distils lessons of the study. It identifies scope for immediate actions by CABRI countries and donors and also some areas for further analysis and monitoring. The paper is organised in three main sections: the first section explains relevant concepts and the reasons for using country budget systems; the second looks at issues and good practices for using country systems at each stage of the budget cycle; and the third discusses the Good Practice Note guidelines on how governments and donors can move forward.

A: KEY CONCEPTS AND THE REASONS FOR USING COUNTRY BUDGET SYSTEMS

5.2.1 Introduction

An essential starting point is to be clear about concepts and definitions. This section highlights the multiple dimensions of aid on budget, and the need for precision in the use of terminology. The terminology distinctions made in the study are closely linked to the rationale for putting aid on budget, which also provided the context and criteria for assessing the quality of aid capture and developing guidelines.

5.2.2 Reasons for using country budget systems

The Paris Declaration commitments reflect a consensus that aid effectiveness depends on country ownership of strategy and country leadership of aid management. Good practice principles adopted at the Rome High Level Forum in 2003 and further developed at the Paris High Level Forum in 2005 are based on the principle of donor alignment with partner countries' strategies and systems in order to ensure this effective country ownership. Using country systems is seen as an important way of strengthening them. It is also seen as a way of ensuring sustainability, since parallel activities often wither when external funding ceases.

Underlying this, there is a consensus about the ingredients of effective public finance management (PFM). The following basic principles of sound budgeting and financial management apply equally to developing and developed countries:

- Budgets need to be comprehensive – include all revenues and expenditures – to enable governments to follow good macroeconomic management and promote allocative efficiency.
- Fiscal transparency – decision-makers have all relevant information – is a driving force for improving fiscal management.
- Transparency is also important to ensure accountability – decisions and their basis, results and costs are accessible, clear and communicated to the wider community – so that decision-makers are held responsible.

Aid constitutes a substantial share of public resources for many developing countries; therefore how well aid is managed is an important factor in how well overall public finances are managed. These good practice principles imply that aid should use country budget systems.

The application of the principles of good budgeting is relevant for each stage of the budget cycle. Sound management of the budget in each stage of the cycle is necessary to ensure good outcomes from spending. For example, a country with a good planning system, but an inadequate budgeting and budget execution system will struggle to realise the benefits of its planning. This is true of aid too. The aid on budget study therefore recognised that if aid is to be more effective, the study should look at principles, issues and country experience of aid in each stage of the budget cycle. The study distinguished between seven dimensions or budget cycle stages, as shown in Box 5.2.1.

Box 5.2.1: Different dimensions of on budget/capturing aid	
Term	Definition
On plan	Programme and project aid spending is integrated into spending agencies' strategic planning and supporting documentation for policy intentions behind the budget submissions.
On budget ³	External financing, including programme and project financing, and its intended use are reported in the budget documentation.
On parliament	External financing is included in the revenue and appropriations approved by parliament.
On treasury	External financing is disbursed into the main revenue funds of government and managed through government's systems.
On accounting	External financing is recorded and accounted for in government's accounting system, in line with government's classification system.
On audit	External financing is audited by government's auditing system.
On report	External financing is included in ex-post reports by government.

Source: Inception Report (Mokoro Ltd, 2007a)

Box 5.2.1 is not exhaustive: there are other dimensions of government systems that may also be relevant. 'On procurement' is an example. Externally-financed expenditures may or may not follow government's standard procurement procedures (even if they are on system in other respects). The aid on budget research noted that the perceived quality of government procurement systems was often an important influence on the capture of aid in other dimensions.

5.2.3 Other key concepts

The study took both the sources and uses of aid into account. Budget documents should clearly show both sources (the financing of the budget) and uses of budget finance (the allocation of expenditures). Rational medium-term planning requires a comprehensive view of financing sources at the planning stage of the cycle, i.e. some years ahead of the annual budget.

When discussing the on-treasury dimension, it is important to be precise about different possible disbursement channels for aid. Three main channels can be distinguished:

1. Channel 1 is the normal channel used for government's own-funded expenditures. Channel 1 aid is disbursed to government's finance ministry (or treasury), from where it goes, via regular government procedures, to the ministries, departments or agencies (MDAs) responsible for budget execution. Note that aid funds in Channel 1 may or may not be earmarked for specific expenditures.
2. In Channel 2, external funds are provided directly to a particular MDA – most often a sector ministry,⁴ and managed through special accounts outside of the regular government system. Thus, Channel 2 funds, although held by a government body, do not follow the normal government procedures.
3. In Channel 3, expenditure is undertaken by the donor agency itself or by non-government agents on its behalf. Assets or services are delivered to government in kind, but government does not handle the funds itself.

Thus funds that are disbursed via government do not necessarily follow regular government channels, and may or may not be on budget. This applies especially to Channel 2 funds, but can apply also to Channel 1. Funds that are not disbursed via government (Channel 3) are often completely off system, but this need not be the case. It is possible for such funds to be anticipated in government plans and to be recorded in government budgets and accounts.

The Paris Declaration commitments cover all aid to the government sector. However,

discussion of bringing aid on budget is often confused by misunderstandings. The following paragraphs clarify five such confusions.

- Aid on budget is not a synonym for budget support. The OECD Development Assistance Committee (DAC) defines budget support as aid that is channelled directly to partner governments using their own allocation, procurement and accounting systems, and that it is not linked to specific project activities. Thus, budget support is, by definition, on budget.⁵ However, other aid modalities, including project aid, technical assistance and other forms of aid in kind can also be on budget.
- Sector budget support (SBS), similarly, should be on budget by definition. But the term is often used inaccurately. Part of the standard definition of budget support (above) is that it is not linked to specific project activities. However, in some country cases, the term sector budget support is used to describe funding that is very tightly earmarked ex-ante to specific budget lines.⁶ Equally, SBS, by definition, uses government's own allocation, procurement and accounting systems. However, pooled funding arrangements that do not use regular government systems are often wrongly described as SBS.
- The term sector wide approach (SWAp) is not synonymous with pooled funding (or basket funds). The discussion about whether aid is on budget needs to consider specific aid instruments, but a SWAp is not itself a specific aid instrument but a way of working at sector level. A SWAp may be supported by a variety of aid instruments: a pooled donor fund is one possibility, but a SWAp may also (and at the same time) be supported by other instruments, including projects and both general and sector budget support (OECD DAC 2006b).
- Projects are not necessarily off budget. The use of parallel systems is a very common feature of externally funded projects, and bypassing country systems has often been part of the rationale for using the project modality. However, it is quite possible for project aid to be on budget at some or all of the stages of the budget cycle. It is therefore very unhelpful to imply that the use of parallel systems is an automatic feature of project aid. Using project terminology in this way can easily reinforce the misconception that shifting to budget support is the only way to bring more aid on budget.
- Bringing aid on budget is not just about donors providing information to governments. Some aid agencies emphasise reporting their aid to governments, while others aspire to integrate their aid with other government resources throughout the budget cycle. However, reporting aid on budget is not the same as making full use of country budget systems, and reporting will not necessarily result in the same benefits as can be achieved from integration.

5.2.4 Understanding institutions and incentives

Putting aid on budget is not just a technical matter. The behaviour of those involved, both on the government and the donor side, will depend on the institutional framework and the incentives they face. Different elements of government have different perspectives, and on the donor side different constraints affect different types of aid and different aid agencies.

Influence of aid instrument characteristics

For the purposes of the study, aid meant official development assistance (ODA), as defined by the OECD's DAC.⁷ ODA includes both grants and (soft) loans, as well as contributions in cash and in kind. Distinguishing between these different types of aid is important, as the use of particular forms of ODA affects the likelihood of aid being captured in budget systems.

Aid instrument characteristics have a strong influence on whether they are likely to be captured in budget documents and budget processes. Budget support is captured (at least in most dimensions) by definition.⁸ Loans are more likely to be captured than grants, because of associated legal procedures and the need to anticipate debt service. Technical assistance and other forms of aid-in-kind are less likely to be captured (especially emergency aid which is less likely to follow the budget cycle). And aid that is disbursed through non-government partners or to sub-national levels of government is also less likely to be captured than aid to the central government.

Influence of aid agency characteristics

Aid agencies have different mandates, report to different constituencies, and operate with differing degrees of flexibility at country level. All these factors may constrain the aid instruments they use. Further, they have different perspectives on aid and different attitudes to risk, including the fiduciary risks associated with using government systems. Although the whole spectrum of aid agencies (along with partner governments) signed up to the Paris Declaration, there are significant differences in how it is interpreted.

Mixed incentives for using country budget systems

The bypassing of country systems over many years reflected a range of donor frustrations, including lack of transparency and accountability in the beneficiary government's use of funds, funds not reaching the intended projects, funds being diverted for corrupt purposes, and demands for greater accountability from donor country parliaments. However, experience with the use of parallel systems to manage projects was also unsatisfactory: the parallel structures further debilitated government

systems by drawing away key staff and resources; donors pursued unco-ordinated development agendas; projects could not in themselves address the poor policy and institutional environment that undermined them; and their sustainability was undermined by the lack of government ownership and of provision for their maintenance and operating budgets. The pendulum has now swung back, with recognition of the need to better integrate aid with beneficiary government policies, budget, and financial procedures. However, donors' worries have not disappeared, and interests on the government side also pull in two directions.

Williamson & Kizilbash Agha (reported in Booth 2008) report on account of sector studies undertaken in Tanzania, Uganda and Mozambique that while finance and other central ministries may prefer budget and programme support modalities, project modalities with parallel funding and management mechanisms generate multiple material and non-material benefits for the ministers and civil servants in whose sectors they are located, including salary top-ups, allowances, vehicles, training and travel opportunities, and prestige. Ministers, parliamentarians and local authorities are interested in the political credit they get for attracting a stand-alone project to a specific sector or area. The resource flows from a free-standing project are visible, reliable and relatively simple to control. The government officials at the sector or local-government level prefer to avoid the unpredictability, rigidities and reporting requirements associated with funding through the national budget, and the reduced control this implies. In addition, dealing with a single donor is simpler than dealing with several through a pooled-funding or budget support arrangement, where donors tend to 'gang up' on the ministry in ways that reduce its discretion.

Supply and demand for information, and its quality

These mixed incentives on both sides of the aid relationship help to explain the weaknesses in the supply and demand for information. The same incentives may result in distortions to information. For example, sector ministries and donors may be reluctant to disclose aid provided directly to the sector if they fear that allocations of other resources will be reduced as a result. Hence it is always important to consider the quality of the information that is fed into the budget process at its different stages. Relevant criteria of quality include the technical quality of information, its timeliness and accessibility, and whether and how information is actually used. The aid on budget study confirmed that the ability to make good use of information about aid largely depends on the quality of the information and processes relating to non-aid resources. Thus bringing aid on budget should be seen as part and parcel of wider PFM reforms.

B: ISSUES AND GOOD PRACTICES FOR USING COUNTRY BUDGET SYSTEMS

5.2.5 Introduction

This section reviews each of the budget system dimensions in turn and considers the relevance of country systems and good practices in using and supporting them. It highlights connections between different dimensions and offers elements in a menu of good practice.

5.2.6 Putting aid on plan

Good practice calls for annual budgets to be guided by medium-term strategies. Especially where aid is a significant proportion of resources, it needs to be factored into the government's medium-term plans. Being able to anticipate the aid that will augment or substitute for domestic budgetary resources in the coming budget year is a minimum requirement. Planners also need to take a view on the availability of aid and other resources over a much more extended horizon. The information requirements for the short and the medium term, and for different modalities, are different.

To bring aid on plan in a useful way depends on government itself having a meaningful planning system. If there is not a credible government planning process, it is difficult to make systematic use of information that donors provide. For donors, it is easy to 'align' with objectives that lack the discipline of prioritisation.

Dual budgeting systems, with separate recurrent and development budgets, are an obstacle to coherent planning and budgeting in many aid-dependent countries. Ironically, development budgets were, in large part, a means of putting aid on budget, but led to substantial distortion and fragmentation of public expenditure management. This issue and some possible remedies are discussed further below.

Aid agency projections

There are systematic biases in the information provided by aid donors. They are very cautious about providing aid forecasts that are not based on firm commitments. This leads to a paradox. Donor projections of disbursements within the budget year tend to be too optimistic (because donors rarely meet their commitments in full).⁹ At the same time, donor projections of aid over the medium term tend to be too pessimistic, because donors are unwilling to make projections above what they have formally committed to, even when they know that new projects and programmes are likely to appear.

The Uganda case study illustrates this problem: aid data provided by donors is

largely based on financial commitments, and donors are either unwilling or unable to provide medium-term estimates of aid other than what has been committed. This presents two problems. First, that aid data provided by sectors and by donor agencies for the budget year are usually fairly comprehensive, but over-optimistic – i.e. in aggregate not all donor commitments are realised. Second, aid projections for the outer years usually underestimate future levels of aid, as existing commitments tail off over the medium term. At the aggregate level, for the purpose of macroeconomic management, the finance ministry tries to make realistic projections of aid, by discounting aid for the budget year in question (different discounts are used for budget support and projects), and making realistic projections of budget support (i.e. projecting it above committed levels) over the medium term. However, at the expenditure planning level in the medium-term expenditure framework (MTEF), donor commitments are recorded as reported.

A number of governments have recognised the biases and uncertainties in donor projections of their own aid flows and respond by discounting estimates of short-term disbursement, and developing alternative scenarios of aid flow in the medium and long term. The Rwanda study provides a good example and rationale for discounting. Because some projects have a poor record of project execution and in the past the development budget tended to be often 'under-executed', expected project disbursements are discounted (at variable rates) in the budget preparation process by the budget department. Amounts included in the development budget are therefore often lower than the disbursement estimates provided by project co-ordinators (who, for opposite reasons, have shown in the past a tendency to over-estimate expected disbursements). Uganda has used discounted estimates of budget support disbursements, based on experience, to avoid authorising unfunded expenditures. Ghana also applies discounts.

Several countries have published different funding scenarios for their poverty reduction strategy papers (PRSPs)/medium-term expenditure plans. Ethiopia describes different expenditure scenarios for different levels of donor funding. Mozambique's most recent PRSP is based on three expenditure scenarios. Because of the unpredictability of its budget support, Kenya does not include budget support in its main budget but only in an alternative scenario expenditure plan. In Tanzania, government and donors are working towards the joint definition of alternative scenarios.

Scenario planning does not in itself address a fundamental inconsistency in donor behaviour: donors collectively aspire to support long-term objectives (the Millennium Development Goals (MDGs)) which require substantial recurrent expenditures as well as investments, yet donor financing instruments are individual and short-term

in nature. Government and donors in Tanzania have been considering alternatives such as:

- donors providing a collective commitment on aggregate for aid flows over the medium term and nominating a donor of last resort (for instance the World Bank)
- establishing a stabilisation fund which would provide funds if aid flows are lower than expected.

Some individual donors (for example, the European Commission (EC)) have also been considering new aid instruments which would provide predictable funding over the medium term.

Progress in strategic budgeting

Government's own progress in strategic budgeting is a key factor in bringing aid on plan. Governments cannot allocate resources efficiently without a whole-budget perspective that enables them to address trade-offs between sectors. The role of the central ministry of finance/planning is crucial. At the same time, many key inputs into strategic planning take place at sector level, so there needs to be good articulation between central and sectoral processes. Government leadership of the strategic planning process is also important. The principles of strategic budgeting are general, but where aid is prominent, it is important to engage donors with a government-led planning process and not to take donor information at face value, but to use it as the basis for scenario planning.

Uganda, Tanzania and Kenya have put in place budget planning structures that engage donors transparently in analysis and review processes in the planning and budgeting phase. In Tanzania the planning and budgeting process structures require the participation of donors and other stakeholders in sector and thematic working groups. In Uganda and Kenya similar structures exist. Positive elements are the transparency of the process and the availability of sector and national budget framework papers to stakeholders in sector working groups and across government. In all three countries, efforts are made to fit systematic public expenditure reviews into the planning and budgeting calendar. Engagement in such processes makes it more likely that information (in both directions) will be provided, queried and used.

5.2.7 Putting aid on budget

Annual budgets are a universal management tool. The formal budget document is the basis of legislative authority for expenditure, and subsequently the basis for

control of budget disbursement and the monitoring of budget implementation. However, there may be deviations between a formally approved budget and what happens subsequently. The budget documents are only a starting point in discovering whether, and how well, aid is incorporated in the formulation, authorisation and implementation of government budgets.

Budget documents may be assessed for how clearly they show aid as a source of finance, and, where appropriate, as the earmarked financing source for particular expenditures. Quality considerations include the level of detail and accuracy of the information, but the most important consideration is whether the incorporation of aid in the budget documents contributes to an effective budgeting process.

Incentives and disincentives for including aid on budget

On the donor side, the most common deterrents to putting aid on budget are the overall credibility of the budget, and the specific visibility of donor funds within it. Credibility is undermined by deviations between budgets and actual outturns. The desire for visibility has a fiduciary aspect (as a means to show that funds have been used as agreed), but may also relate to an agency's broader need to be able to demonstrate that its aid has made a difference. Thus, government classifications which make it hard to identify different uses and different donors tend to discourage aid from coming on budget.

Good practice: Priorities for public finance management reform

PFM reform programmes should seek to increase the willingness of partners to bring aid on budget by increasing the budget's credibility, as well as facilitating the practical process of incorporating aid in the budget. Key (interlocking) areas for PFM strengthening to bring aid on budget thus include budget classification reforms that enable sources and uses of funds to be clearly identified in the budget and monitored during budget execution; measures to ensure budget discipline so that there is close correspondence between budget and outturns; and a planning and budgeting calendar that shows when donor inputs are required. All of these reforms are essential for strengthening the domestic PFM system; their role in encouraging the integration of aid is secondary.

Good practice: Joined-up budgeting – recurrent and development budgets

Development budgets often originated as a way to make donor (and investment) funds visible on the budget. However, from being part of the solution, they became part of the problem – distorting the budget and the budget process, and accentuating fragmented planning on the government side. Negative experiences with dual

budgeting demonstrate the need for coherence in planning (and therefore aid coordination) on the government side. It helps if the same people are managing both the recurrent and the development budget for each sector/agency. Part of the distortion of dual budgeting happens when the development budget becomes an aid budget, with aid funded recurrent costs and technical assistance misleadingly included in what is nominally an investment budget. Donors need to be transparent in their financing of recurrent costs, and realistic about the likely duration of such financing.

Recent reforms in Rwanda illustrate one way of integrating recurrent and development budgets. From the 2008 budget the recurrent and development budget will be jointly presented under each ministry in a consolidated budget, instead of having a separate development budget covering donor projects. The same chart of accounts will be used to classify both domestically financed expenditures and donor projects, but will clearly separate recurrent and capital expenditures. The integration of projects into the national budget will also require training of project coordinators and line ministries to ensure that the new budget classification is applied appropriately to projects, and subdividing big, multisectoral projects into project components in order to ensure they are accounted for where they belong (sector, ministry, programme) instead of being lumped in one place. (See Chapter 4 in this volume for a discussion on capital budgeting approaches.)

Good practice: Showing broadly how aid has been used

Keeping aid off budget is one strategy for an aid agency that wishes to ensure that its aid is separately identified and channelled to specific activities. However, such earmarking can be accommodated on budget if the budget codes are able to identify both the sources and the uses of funds in detail (and if the regular accounting system provides timely and credible reports in the same format). The potential damage to the budget system is less if earmarked aid first enters the budget system upstream, during the planning phase.

For many donors, however, earmarking is not an end in itself. They have a broader concern that their aid should add to the total resources addressing particular objectives (for example, to achieve the MDGs for health or education). A number of countries have adopted broader tracking mechanisms which, in the context of dialogue with aid partners, help to demonstrate the focus and the contribution of aid, without requiring programmatic aid to be strictly earmarked to particular budget items.

In Uganda a notional poverty action fund has been used to channel Highly Indebted Poor Countries (HIPC) resources and budget support to priority sectors, and to identify budget lines that are protected from within-year budget cuts. In

Ethiopia, the protection of basic services (PBS) project supplements federal grants to regions and districts, enabling them to maintain and expand primary health, education and other services. Aid agencies and the federal government jointly monitor the additionality of PBS funding, the fairness of sub-national allocations, and regional/district performance, but without compromising local authorities' discretion to manage their own budgets. In Tanzania, the strategic budget allocation system (SBAS) links budget spending not to priority sectors in the poverty reduction strategy but to priority outcomes.

Good practice: Making budget information more accessible to internal and external audiences

Budget information is often hard to digest, and this can undermine the quality of intra-governmental, parliamentary and public debate. Nowadays, the Internet makes it much easier to publish budgets and information on expenditures. However, the budget is often very voluminous and presented at a level of detail that may be necessary for administrative purposes, but which obscures its strategic themes and purposes. Additional documents and summaries can increase transparency by showing how the budget reflects the development strategy, how the annual budget fits into medium-term plans, and, of course, how external finance is being used. It is important that these additional documents are rooted in the legal budget document, and are not separate documents arising out of separate planning processes. Where this is the case – as with the Burkina Faso programme budget – such documentation has very little real effect on the budget process.

5.2.8 Putting aid on parliament

One of the principal arguments for using country budget systems is to strengthen the accountability of national institutions for the use of resources. In many aid-recipient countries, parliament is a weak link in the chain of national accountability.

The strict interpretation of putting aid on parliament is that external financing should be included in the revenue and appropriations approved by parliament. Parliament is legally responsible for authorising expenditure by the executive branch, and inclusion of aid within the appropriated budget signifies that the executive should be accountable to parliament for aid-funded expenditure. In practice, however, aid may be brought to parliament's attention in ways that fall short of formal appropriation. Three levels of parliamentary involvement may be considered: at the level of the strategic framework for budgets, at the level of approving annual budgets and particular aid agreements, and at the level of reviewing audit reports.

Good practice: Helping to strengthen parliament's role in the budget system

Reasons for weak parliamentary engagement in budgeting are deep-seated and not likely to be quickly transformed. Issues with whether and how aid is on parliament have little to do with how aid is managed, but rather with how the budget as a whole is managed. Nevertheless there is merit in:

- ensuring that legal requirements concerning parliament's role are observed
- ensuring that parliament is well informed about aid flows even in cases where it does not formally approve them
- strengthening the engagement of parliaments in the budget process generally, for example through engagement in medium-term strategies, improving the accessibility of the budget and strengthening parliamentary procedures and staffing
- supporting civil society efforts to scrutinise government's public expenditure
- seeking accountability to donors in ways that complement, and do not undermine, government's domestic accountability, including accountability to parliament.

5.2.9 Putting aid on treasury

The study defined aid as being on treasury when 'external financing is disbursed into the main revenue funds of government and managed through government's systems'. The rationale for putting aid on treasury is to support government's financial management systems and capacity, to facilitate efficient cash management and reinforce financial discipline, and to facilitate aid capture on other dimensions.

Not all funds channelled to government bodies are on treasury. Equally, aid may be on budget without being on treasury. However, on treasury is a pivotal dimension. Thus, when aid is disbursed through the treasury system, the treasury has to be provided with necessary information to trigger disbursements, and this supports the on budget and on accounting dimensions too. At the same time, it reinforces financial discipline.

Both donors and government agencies have incentives to keep aid off treasury, and beyond the immediate control of the central authorities, in order to boost their own control of resources. There may also be a more legitimate fear that disbursement via treasury will be inefficient in reaching service-delivery levels.

Good practice: Priorities for PFM reform

The same features of PFM systems that are important for bringing aid on budget are also relevant to bringing aid on treasury. In order for donors (and beneficiaries) to have confidence in the treasury system, it is particularly important to address both the discipline and the efficiency of treasury disbursement. Measures that have been effective in the case study countries include the strengthening of expenditure processing linked to reformed budget classifications and capacity building. In some cases (for example, the electronic state financial management system (SISTAFE) in Mozambique) the introduction of the integrated financial management information system (IFMIS) modules has contributed to the strengthening of treasury systems.¹⁰

Across a range of countries, the introduction of single treasury accounts (STAs) and related efforts to strengthen bank account management have had a strong effect. Mozambique provides an example. The Mozambique government, together with its aid partners, has been working to merge all financial accounts into one single treasury account. Donor agencies that belong to the Programme Aid Partners group have agreed to disburse at least 60 percent of their development assistance to government through the single treasury account system by 2009. As of 2007, some of the larger sectoral common funds are now being managed through the STA and are, therefore, on treasury. The establishment of the STA directly addresses one of the main causes deterring donors from using local public financial management systems: the lack of transparency within the treasury system.

Ghana and Rwanda are among other countries pursuing similar reforms. In Uganda, as a separate measure, the government has required bank accounts for project aid to be held at the central bank, rather than commercial banks; this has improved information and supervision by the accountant-general.

Good donor practices to bring aid on treasury

Donors can contribute to more effective aid capture on treasury by reviewing their own (headquarters) requirements and guidelines on the use of the country systems, in order to remove obstacles to the use of country systems that are unintended or unnecessary. In the design of aid programmes, donors should give early attention to the design of disbursement procedures when preparing aid interventions and take into account the nuts and bolts of the partner country's PFM system. Donors can contribute further by improving the predictability and front-loading of budget support disbursements to assist government's liquidity and cash-flow management.

5.2.10 Putting aid on accounting

Aid is defined in Box 5.2.1 as on accounting when 'external financing is recorded and accounted for in government's accounting system, in line with government's classification system'. Aid is not fully on accounting if donors demand special additional financial reports. (See discussion of report below.) The rationale for using the government accounting system as much as possible is to strengthen government financial systems, to minimise transaction costs and demands on government capacity, and to ensure that government accounts provide a comprehensive view of its finances.

Aid may simultaneously be on accounting and not on some other dimensions. For example, there are ways in which aid that is not on treasury, or not appropriated through the budget, may still be recorded in government accounts. However, there is valuable synergy if aid is on treasury as well as on accounting, since the need to justify disbursements provides a strong incentive to keep accounting records up to date. Credible and timely accounting for disbursements may be a crucial factor in aid agencies' willingness to use Channel 1.

Good practices for bringing aid on accounting

The key good practices for governments seeking to bring external funds on accounting are to ensure that the accounting system provides a proper framework for reporting transactions, including those involving external funds and to undertake capacity development to ensure the quality and timeliness of government accounts at all levels.

There are now internationally recognised accounting standards for aid which provide attainable standards for countries using cash-based accounting systems – see Box 5.2.2.

Box 5.2.2: Good practice: Follow international accounting standards for aid

Since 2005, the International Public Sector Accounting Standards Board (IPSASB) has undertaken a consultation process on exposure drafts to amend the cash-basis International Public Sector Accounting Standards (IPSAS) to include additional required and encouraged disclosures for recipients of external assistance, issuing Exposure Draft (ED) 24 in 2005 and ED 32 in 2006. ED 32 proposes a split into mandatory and recommended disclosures under the cash basis of accounting. The mandatory requirements include: 'show separately total external assistance received in cash, show [aid in kind] i.e. payments made on government's behalf by a third party, break down by different providers, show grants and loans separately' and others. Following field tests in 2007, the IPSASB approved IPSAS, *Financial Reporting Under the Cash Basis of Accounting: Disclosure Requirements for Recipients of External Assistance*. The IPSAS (to be housed within the cash-basis IPSAS), is planned to be issued early in 2008. Full details are available from the IPSASB

Source: www.ifac.org/PublicSector/ProjectHistory.php?ProjID=0067

Since disbursement through treasury is not feasible for all donors (or appropriate for all types of aid), mechanisms to record aid-in-kind in government accounts are a good practice. In Tanzania the accountant-general issues a dummy exchequer issue notification to introduce aid-in-kind (i.e. parallel aid flows that purchase inputs outside of government systems) into the government accounting system. After the donor has disbursed funds or goods and services directly to the third party agent involved, the project reports on the amounts, goods and services or equipment value received to the government agency with the supporting evidence. The agency then raises a payment application form, but since the expenditure has already been made, attaches the payment vouchers and other supporting documentation. The budget division then grants a release warrant to the accountant-general, who issues the dummy notification. That registers the expense in the accounts.

For donors who are not disbursing through Channel 1, good practice requires the timely provision of expenditure information in formats that match the government's accounting classifications (see also the discussion on report, below).

5.2.11 Putting aid on audit

Aid is on audit when 'external financing is audited by government's auditing system' (Box 5.2.1). The rationale for using national audit systems is to conform to national lines of accountability and to support the strengthening of national systems. The formal question is whether aid is included within the scope of government audits, but an equal concern is the quality of the auditing that takes place. Donors (and especially budget support donors) have an interest in the auditing of domestically-financed expenditures as well as of aid. A precondition for audit is the submission of timely accounts. Weak national audit capacity and delays in completion of government accounts are two main reasons that donors may seek separate audit of their funds.

Good practice: Support to audit capacity

Support to the capacity of audit bodies is likely to be a long-term requirement, and could complement long-term action to strengthen parliamentary public accounts committees, as well as civil society demand for accountability. Direct support can be complemented by efforts to strengthen the demand for audit services. For example, in Uganda, in the context of the move towards budget support, the auditor-general has benefited from significant institutional support in recent years, and also the timely preparation of audits has been a key focus of conditionality. This has helped underpin improvements in quality and timeliness of audit reports. Similar developments are taking place in Mozambique where, with the growth of budget support to the government, several donors have started supporting the administrative tribunal (the

body responsible for external auditing) with various capacity building initiatives that have improved the scope and quality of its audit exercises on the budget, including its externally funded components. Where special audits are to be commissioned, donors can avoid sidelining national audit authorities by involving them in the commissioning of audits. (In several countries, such involvement is required by law.) There is also scope for harmonisation of donor audit requirements (as happens through various forms of pooled funding).

Good practice: Complementary approaches to fiduciary and other assurances sought by donors

Formal ex-post audit is only one element of fiduciary assurance. Donors often seek much more immediate comfort about the use of their funds, and are concerned with wider questions about how well resources are used. Relevant complements include internal audit as an aspect of the control environment when funds are put on treasury, ongoing financial reports and reviews to verify the application (and in some cases the additionality) of aid funds, and diagnostic studies such as public expenditure reviews and public expenditure tracking surveys. There is thus a need to think broadly about the range of audits that may be required, both for accountability and for monitoring and improving aid effectiveness, and to implement these in ways that engage governments and harmonise donor efforts.

5.2.12 Putting aid on report

In the on-report discussion, the aid on budget study considered whether external financing is included in ex post reports by government. This dimension acknowledges that the monitoring of public expenditures involves a much wider range of (financial and other) reports than those provided by the formal accounting system. It is possible that aid which is not incorporated in the formal public accounts may nevertheless appear in such reports.

The definition of relevant reports is rather open-ended. The aid on budget study focused on reports that are owned by governments, and which are consolidated. In addition to the formal accounting records that are produced, there is potential for other reports (for example, budget execution reports, consolidated sector reports) to provide valuable management information and to integrate externally funded activities in the process.

Good practices for reporting and information sharing

Reporting has costs, and the quality of reports depends on reporters having a continuing incentive to provide timely and accurate information. Consolidated

reports can add value by capturing more aid than is directly reflected in government's financial management systems, especially if financial data can be linked to information on activities, outputs and outcomes. They may provide useful consolidation.

Incompatibility of reporting categories, timetables and formats is a continuing challenge. Donors need to adapt to government, classifications, currency, time periods and reporting timetables in order to increase the value of such reports. At the same time, demands for reporting should take account of capacity, and be linked to efforts to strengthen analytical capacity in particular.

On the government side, there is need for coherence and discipline in dealings with donors. There is often confusion and duplication of effort when separate planning and finance departments seek overlapping information in different formats, when sector ministry efforts are not co-ordinated with the centre, and when aid co-ordination functions are disconnected from the budget function (which can happen both at the central level and within sector ministries).

The aid on budget study found that databases often proliferate and are poorly linked to each other. There is scope for rationalisation, in which governments should lay down clear channels of communication, both within government and between donors and government bodies. Databases which focus on external aid can be useful, but they are not in themselves a solution to bringing aid on budget¹¹ – they may improve the sharing of information, but this is only a first step towards the integration of aid with country systems.

5.2.13 Using and supporting decentralised budget systems

In all cases, decentralisation poses a special challenge to bringing aid on budget. On the one hand, aid that is channelled to decentralised bodies or focused on specific geographical areas is often hard to capture for planning and budgeting purposes. On the other, one of the deterrents to bringing aid on budget is a fear that disbursement via central government (Channel 1) will not reach local levels fairly or efficiently.

Mozambique is a prime example of this dilemma. Government and aid partners have worked to bring more aid on budget, through pooled sector funds; these efforts have been linked to the strengthening of financial management subsystems and the introduction of a computerised financial management system. There has been substantial progress, but the delivery of resources to local level through the government system is still problematic.

The aid on budget study included a review of Uganda's experience in channelling aid through the budget to decentralised services. Important in this case was government developing a clear and transparent fiscal transfer system, where grants to local governments are transparently determined and clearly identifiable in the budget.

The Uganda system also addresses donor fiduciary concerns directly by developing initiatives which ensure that transfers are protected and can be tracked, while strengthening budgeting systems at the local level. The Uganda case demonstrates firstly that capacity can effectively be built while using the inter-governmental transfer system and local government systems, even from a very weak starting point. Demanding the capacity from local governments helps build it, particularly when supported by capacity development and incentives. It also demonstrates that strong government initiative has helped bring aid on both budget and on financial management systems in local governments. This has meant that off-budget pooled funds became far less prevalent in Uganda than other similarly aid-dependent countries (for example, Tanzania and Mozambique).

C: HOW GOVERNMENTS AND DONORS CAN MOVE FORWARD

5.2.14 Introduction

This section looks at lessons of experience in using and strengthening country budget systems. It re-iterates the good practices already identified, but in the context of ways that governments and donors, individually and together, can make progress in the spirit of the Paris Declaration. It also suggests how to identify priorities for progress in individual partner countries, and by individual donors.

5.2.15 Overall approach to improving aid capture

The country studies highlighted the ways in which government and donors working together (especially if led by government) can make progress in strengthening effectiveness, including putting aid on budget. Often the dialogue around budget support and SWAps is a valuable focus. Accordingly, the most striking gains in bringing aid on budget have been through the use of budget support and by bringing pooled funds on budget.

Improvements in PFM are a fundamental factor in bringing aid on budget. At a general level they can increase donor confidence in government systems, and support a virtuous circle in which the integration of aid in country systems strengthens those systems and encourages the further integration of aid. At a specific level, the nuts and bolts for integrating aid are the nuts and bolts of the PFM system.

Where are the potential gains?

Budget support is automatically on budget in most if not all dimensions. For this and for other reasons it makes sense for partner countries to create favourable conditions for (general and sector) budget support, and to encourage donors to provide more

of their aid in that form. There are risks attached to budget support, for recipients as well as donors, and it is in both sides' interest to design forms of budget support that mitigate these risks. This includes seeking a balance of complementary general and sector budget support operations.

However, budget support has limits, and project aid has been growing. The problems associated with poorly integrated project aid still loom large. The bigger challenge, therefore, is to bring project aid on budget. While the shift to budget support is the most efficient and comprehensive way of putting aid on budget, it has in many cases so far led to less concrete results in terms of reducing the number of projects or project-type funding. In many of the countries the shift to budget support has meant a reduction on programme-based, often basket-funded, modalities.

A lot of progress can be made therefore by improving the way projects are integrated. In fact, making sure all aid modalities are reflected on the budget is only a first step in the process. It is an essential step, since transparency will allow better planning, allocation, and accountability.

However, in all cases it is essential for donors and governments to push the reflection further than mere data collection, in particular towards how to ensure project planning and pipeline are aligned to government priorities, how projects can be integrated into the single treasury account, and how project execution can pass through government financial management systems and abide by local PFM legislation.

Despite several countries having paid special attention to designing procedures for managing externally financed projects within government systems (Tanzania is a leading example), in other cases the integration of projects has been surprisingly neglected. In Uganda, for example, mechanisms have not been developed for externally financed project expenditures to use government accounting systems. This is because it has been widely perceived that projects would disappear over time. Yet project aid has remained and is now growing again.

Generally, the neglect of the project dimension by both donors and governments reflects the incentives discussed above, which still militate against the use of country systems. However, it is the area where significant gain can be made to make aid more effective and strengthen country systems despite project modalities being in use.

Priorities and sequencing

Different countries have different institutional settings, their governments have different preferences in how they relate to donors, and their PFM systems are at different stages of development and reform. Strategies for bringing aid on budget need to be tailored to these different circumstances. Relevant considerations include:

- Aid on budget issues are generally more important in more aid-dependent countries.¹²
- Sectors where substantial aid flows support public services merit more attention.
- Capacity everywhere (including aid agency capacity) is limited, and in any case technical solutions will not work unless incentives are right.
- Bringing aid on budget needs to be considered as part of an overall strategy for PFM, which will have a strong influence on the sequence of reforms.

The analytical framework for the study should be a useful template in considering the choice and design of aid instruments. It is worth considering which dimensions are more important in a particular case, and whether disadvantages of non-capture in some dimensions can be mitigated on other ones.

5.2.16 Recommendations for governments

The PFM agenda

Bringing aid on budget – in the broad sense of maximising the use of country budget systems – should be seen as part of the overall PFM reform agenda. It should be addressed within the comprehensive, country-led programmes of PFM reform. It is important for governments to publicise their systems, highlight improvements, and make their procedural requirements known to donors.

The following PFM priorities are especially relevant to the integration of aid within country systems:

- strengthen transparent medium-term expenditure planning (to bring aid on plan)
- clear planning and budgeting calendar to integrate aid management with the planning and budgeting process
- better budget classification and presentation
- discipline in budget execution, reinforced by, among others, single treasury accounts and strict control of government bank accounts, more timely reports and accounts
- transparent and efficient mechanisms for funding sub-national governments
- more transparent budget documents to highlight plan/budget strategic links:
 - to show aid sources of budget finance, and aggregate uses of aid
 - to facilitate more meaningful parliamentary review
 - to promote better public understanding in both donor and recipient countries.

Strategies for aid management

Few countries have well-articulated strategies for the management of aid (as opposed to its mobilisation). Often the responsibilities for aid management within government are poorly defined, and the lines of communication with donors are confused. Preferences for budget support may be stated, but there is little guidance on how donors should deliver other forms of aid in ways that use country systems. The interconnections between aid and PFM are not always recognised.

Explicit aid effectiveness strategies should:

- Link aid management strategy to strengthened public finance management reform (effectiveness of all resources). The link begins with the making of policy through the budget process, and continues through all the phases of the budget cycle.
- As part of this: address unclear and overlapping responsibilities for the coordination of planning and budgeting, including the integration of recurrent and development budgets and the need to avoid disconnecting aid management and budgeting responsibilities.
- Go beyond indication of preference for budget support modality, to specify good donor practices and standard government procedures for other modalities.
- Allow for strategic dialogue about the use and the additionality of aid funds.

The Ghana government is in the process of developing a comprehensive aid policy, known as the external resources mobilisation and management policy. It is currently at the concept note stage. The strategy is in response to government and donor concerns expressed following the results of the 2006 Paris Declaration survey. The survey revealed a lack of shared understanding between parties on the definition and concepts related to aid effectiveness. It also revealed fragmentation of donor efforts due to a lack of guidance in the allocation of foreign aid, the unco-ordinated provision of technical assistance and inconsistency in reporting on grants and loans, coupled with substantial differences in the data available to government and development partners. All in all, there was a lack of comprehensiveness of aid on budget. There is also the recognition of a need for stronger government leadership and guidance for improving aid effectiveness. The aid policy will include criteria, guidelines, and procedures for: the mobilisation of aid resources; procedures for handling different types of aid; aid reporting; and guidelines for improving sector policy frameworks. It will also specify the roles and responsibilities for aid management at all levels of government.

5.2.17 Recommendations for donors

The Paris Declaration commitment to increase the use of programme-based approaches should provide continued impetus for the greater integration of aid with government systems. Aid agencies should review their aid instruments design, centrally and at country level, from the perspective of aligning and integrating with country systems along each of the dimensions highlighted in this paper.

Agencies should in particular review the extent to which they use regular government systems. This requires investing in understanding the systems and procedures of specific recipients, and training aid agency staff accordingly. It is important to make the use of government systems a design consideration in the early stages of designing any intervention, not an afterthought.

Agencies should also improve the medium-term predictability of their aid (an area in which there has been relatively little progress) and provide aid flow information that is linked to the government fiscal year, the government planning and budget calendar, and government budget classifications.

Overall, most donors need to be more serious in ensuring that their headquarters' commitment to the use of country systems is translated into practice at country level.

5.2.18 Recommendations for joint action

Working together, governments and their aid partners should:

- recognise the continuing importance of joint government-donor action (at general and sector level) to address the greater use of government systems
- incorporate objectives, and set specific targets, for the greater use of country budget systems within country-led public finance management strategies, and within joint aid effectiveness strategies
- strengthen monitoring of the Paris Declaration commitments both internationally and at country level. (This should include monitoring the proportions of project aid that use different elements of country systems.)
- rationalise aid-related databases and collaborate in sharing information on all types of aid.

5.2.19 Next steps

Many steps can be taken in the short term, but a long-term perspective is required. The process of putting aid on budget is likely to require time and a long-term perspective from all parties involved, and a gradualist approach that takes into account the many interdependencies that exist between the various policy spheres if these objectives of bringing aid on budget at all levels of the budget cycle are to be achieved. Many of the good aid on budget practices identified in the study are general good practices. Using country budget systems is part of a wider agenda for aid and public finance management. Pursuing aid on budget should not become a separate, fragmented chore; it should be incorporated in wider programmes for PFM strengthening, and included among the tasks of existing general and sector forums for dialogue between country governments and their aid partners.

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Endnotes

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2. This paper is a summary of the aid on budget study outputs, including the case studies, Literature Review, and Synthesis Report. It draws heavily on the Good Practice Note. The outputs can be found on the CABRI website, www.sbo-africa.org. Full references are in the bibliography.
3. It should be clear from the context if 'on budget' is meant in a more general sense than this precise definition. In this paper the term 'on system' is also used to refer generally to the use of country systems in the management of aid.
4. Channel 2 funds may be administered by a project implementation unit (PIU) under the control of government.
5. However, the aid on budget study found examples where budget support was not made clearly visible in budget documents as a source of finance.
6. The aid on budget study described such cases in Mali and Burkina Faso.
7. Grants or loans to countries and territories on Part I of the DAC List of Aid Recipients (developing countries) which are: (a) undertaken by the official sector; (b) with promotion of economic development and welfare as the main objective; (c) at concessional financial terms [if a loan, having a Grant Element (q.v.) of at least 25 percent]. In addition to financial flows, Technical cooperation (q.v.) is included in aid. Grants, loans and credits for military purposes are excluded. (Development Cooperation Directorate, DAC's Glossary, www.oecd.org.)
8. However, the aid on budget study found examples where budget support was not made clearly visible in budget documents as a source of finance. Late notification and unpredictable disbursement may also make it difficult to capture budget support on plan.
9. Even if committed funds are fully available, expenditure may fall short, especially if funds arrive late in the budget year.
10. However, introduction of an IFMIS is not a panacea. Research reported in 2004 (cited in Parry 2004) showed that for 34 IFMIS projects in 27 countries funded by the World Bank (at an average of USD12.3 m per country):
 - only 21% were successful
 - only 6% were regarded as likely to be sustainable
 - they took an average of seven years to complete.
11. See the remarks on IFMIS above.
12. On the other hand, less aid-dependent countries, such as South Africa, tend to have stronger PFM systems. Therefore, while putting aid on budget in these countries may be less critical, it should also be easier, and donors should take advantage of this.

