

**INSTITUTIONAL AND INCENTIVE ISSUES
IN PUBLIC FINANCIAL MANAGEMENT REFORM
IN POOR COUNTRIES**

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1. Introduction¹

This paper looks at the incentives facing the main players and institutions in public financial management reform, and how this affects outcomes. The focus is low income countries, typically those accustomed to high inflows of aid, participate in HIPC debt relief, and are attempting financial management reform, closely monitored by donor agencies. It is based on the practitioner experience rather than specific research, and its purpose is to raise issues for further investigation, rather than provide definitive findings. It strongly supports deepening the programmatic approach to PFM reform which is being developed by the joint Bank/Fund/PEFA Public Expenditure Working Group. The writer's experience is chiefly that of countries in the Anglophone administrative tradition, and this is reflected in the examples given. But most of what is described below is valid for poor countries regardless of their administrative backgrounds. The point of departure is PEFA's discussion paper for a Budget Formulation Module, prepared by Feridoun Sarraf.² The present paper goes on to look at institutional and incentive issues in budget implementation, accounting and auditing. The paper takes the Bank's standard recommendations, and explores whether they are likely to be aligned with the institutional and personal incentives of those at the receiving end of Bank advice, and who are expected to implement it.

The Budget Formulation discussion paper notes the relatively disappointing progress with improving budget preparation performance. It observes that while the main guidance manuals of the international agencies and bilateral donors emphasize "the basics", these are never adequately defined, and the result is a tendency towards budget reform modules based on more advanced country best practice, an uneasy transposition with a high risk of stalled implementation and failure. Similar observations are made in reviews of Bank diagnostic instruments, such as PERs, CFAAs and CPARs, in the areas of budget implementation, reporting, accounting and auditing. These instruments, particularly the latter two, hold a template of best practice against country performance. Although more recent examples have tried to be more selective, this approach generates a "Christmas tree" of recommendations, many of which are shown not to have been acted upon when a subsequent mission comes to review performance.

Several explanations are advanced for the slow uptake by many poor countries of Bank advice. A central proposition of this paper is that existing public financial management practices in poor countries, for all their observed dysfunctionality, are remarkably stable. The reason for this is that in a multitude of different ways, stakeholders have adjusted to poorly performing systems, and have learned to come to terms with their deficiencies and, in some cases, draw benefit from them. In a larger

¹ This paper represents the views of the author and not necessarily those of the PEFA partners.

² Developing the Budget Formulation Module in the Context of a programmatic Approach to the Public Financial Management Reform. Draft Discussion Paper, February 9, 2004. This has six organizing headings: (i) legal and institutional framework, (ii) fiscal sustainability and responsibility, (iii) budget coverage and comprehensiveness, (iv) integration of recurrent and investment budgets, (v) budget classification and budget documents, (vi) orderliness/timeliness of budget preparation process.

sense, the informality which characterizes these systems may in turn be more consistent than the formal rules of public financial management with the country's actual governance reality – the way in which political power is exercised. It also argues that the performance of public financial management systems cannot be viewed in isolation of the human resources situation in governments, particularly the condition of the civil service, the loss of skills, the inadequate pay received by professionals and managers, and the imperative this creates to develop alternative sources of income.

These budget and financial management systems have been around for at least 40 years in most countries. Their roots are in the colonial era when the foundations of public financial management were laid. The present formal rules, however, date from the time of independence, when constitutions were drawn up and budget systems were adapted to the new role of government in national planning³. Few changes of any consequence have been made to laws and regulations since then. When there have been innovations, these have been introduced by external consultants, and were typically focused on budgeting alone. Mostly they gained only temporary traction, organic finance laws were seldom changed, and practitioners soon returned to the traditional process⁴. This means that the formal rules for budgeting and financial management have hardly altered during the professional experience of today's senior civil servants, and the working life of middle and junior staff who implement them. Thus they have become a well entrenched "default" setting to which systems return if reform attempts to introduce new practices falter. And their standing has increased because newly empowered legislatures, many of whose members are former civil servants, are using them for leverage over the executive.

However the formal rules are only part of the picture. How budget and financial management systems are actually operated depends on the interaction between formal and informal rules – the institutional and individual incentive systems that stakeholders respond to. But unlike more advanced countries where there is congruence of rules, in poor countries there is a mismatch. Here the formal rules (and the principles behind them) are mostly in tension with the informal practices have developed over the years,

³ Dual budgets date from around this time, as mechanisms to implement national plans which began to be prepared in poor countries, in some cases prior to independence. Many organic finance laws passed at the time of independence provide for a Development Fund, created as colonies began to access loan funds from the metropolitan power, and public spending, in anticipation of independence, gradually became more developmental. The Development Fund was part of the Consolidated Fund into which aid receipts and borrowings would be paid to finance development projects in the capital/investment budget.

⁴ Some countries attempted during the 1970s to introduce program budgeting, often influenced by the example of PPBS in the United States. These efforts were heavily dependent on external consultants, typically provided by UNDP or USAID, and were soon abandoned. That a country once attempted to introduce PB can often be detected from the layout of the budget estimates, which may contain an extra column labeled "targets", or a departmental structure dressed up as a program. A more long running example of budget innovation was the Forward Budget in Kenya, which had budget department officials preparing three year Forward Estimates as soon as the Annual Estimates were completed. These were assembled in the same detail as the annual estimates in a largely mechanical way. The effort nevertheless required continuous support of external consultants, appears to have little impact on the quality of budgets. The effort began in the late 1970s and was abandoned about fifteen years later. It has now been replaced by a MTEF.

and especially since the collapse of national planning and the impact of structural adjustment on the public sector. The informal rules are rational responses to the incentives with which budget actors are faced. These incentives arise partly from local circumstances, such as the collapse of conventional incentive systems, most egregiously civil service pay and conditions, the demands of ministers, and the decay of accountability.

As already noted, one of the strongest factor locking in the *status quo* is the collapse of civil service pay structures. Although progress has been made in some countries restoring pay, even on a selective basis, the sheer numbers in public employment limit the extent to which this can be done, and most middle and senior civil servants get by through a mixture of low pay, allowance manipulation, private earnings (which may in part derive from their official positions), donor supplements, and outright rents. While one might think that such conditions would spur reform, they do not. The survival mechanisms that individuals have developed (drivers operating government vehicles as private transport, middle level staff augmenting pay with project supplements, professionals writing reports as private consultants, and senior officials taking procurement commissions from contracts) derive from the existing environment. Reform threatens that environment, and the intricate pay augmentation mechanisms that have evolved to cope.

Linked to this is the sheer difficulty of day to day life that our counterparts grapple with, which affects not just their ability to do their job, but the manner in which it is done. This translates into a system which is very difficult to shift from its present equilibrium. Reform minded managers themselves may be trapped by the exigencies of their own pay situation. They may be unable to get subordinate staff to tackle additional tasks – to stay late in the office working on new policies or a re-organization strategy requires additional incentives. And changing the way things are is always threatening. It may re-open old organizational rivalries or threaten patronage networks which exist in all large organizations, both in rich and poor countries, on which many depend for protection.

Powerful incentives are also created by the aid process, on whose resulting flows poor countries have become increasingly dependent. The effect is not just measured by the relative size of aid flows in the budget (generally a much higher proportion than two of three decades ago), but by the intensity of donor demands on recipient governments, both individually and collectively. It would be wrong to classify the latter as either uniformly negative or positive, reality combines both. What is becoming increasingly clear is that donors have become a major influence on the institutional and individual incentives that stakeholders respond to. For a long time the impact of donors on recipient budgeting and financial management systems was not recognized, and their interventions were uncoordinated and the effects unintentional. This is now changing as donors engage governments through the HIPC/AAP process and seek explicit indicators of financial management performance. Indeed, donors have become the dominant factor in budgeting in poor countries.

A further set of incentives impacting on public financial management systems is the political dimension in poor countries. This is discussed at various points in the text, and has been evolving over time. While the return of democratic governance in many countries represents a vital gain in governance, and should lead ultimately the development of strong mechanisms to hold governments accountable to legislature and citizens, in the short run countries have to grapple with the cost of financing competitive politics, which in turn may put public financial management systems under extreme pressure.

Overall, renewed attention to the basics of public financial management through diagnostic work and the HIPC/AAP process is welcome. However, to contribute constructively to financial management reform in such countries, external actors like the Bank need to understand stakeholder incentives better, and shape them so as to achieve more positive outcomes. To a greater degree than acknowledged, this lies within the power of donors. The corollary is that donors need to make a greater effort than so far to map and understand the informal incentives affecting counterparts in poor country governments, both those that arise out of domestic circumstances, and those that are rooted in the aid process. Donor practices have also impacted on the formal rules of the budget system, often undermining them in unintended ways. The ways in which this happens, too, need to be understood better, and changes made. The international community is beginning to realize this, and the programmatic approach to PFM is an effort to correct this. Donors, as they press forward with the public expenditure and financial management reform agenda need to understand both the formal systems operating in countries and the incentives and informal practices that both local circumstances and their own actions generate. As this knowledge deepens, the potential for positive outcomes should grow.

This paper is a preliminary exploration of this territory, starting with the framework proposed for the Budget Preparation Module, and then moving on to consider budget execution, reporting, accounting and auditing. It also covers government procurement, a growing area of interest to donors in recent years, and a critical determinant of how well public funds are spent.

2. Budget Formulation

(i). Legal and Institutional Framework

Bank and Fund reports in the past largely ignored the legal and institutional framework for public financial management, in effect taking it for granted. More recently, CFAAs and ROSCs have obliged staff to thoroughly document organic finance laws and regulations and assess the capacity of the organizations responsible for applying them. As far as budget laws are concerned, most reports conclude that while the basic principles of public financial management are adequately reflected, the laws and their subordinate regulations could benefit from updating and modernization. More specifically, greater emphasis could be placed on transparency, the accountability of

budget holders could be sharpened, accounting standards better defined, contingent risks identified, and the coverage of public financial management made more explicit.

While these observations are usually fair comment, the new attention of the Bank and the Fund to the legal framework does raise questions which go to the heart of how public financial management is conducted in poor countries. What is the real traction of the formal rules for budgeting preparation and execution, and why have poor countries, unlike many OECD ones, not made a greater effort over the years to update their frameworks, as approaches to PFM have evolved?

One argument is that there is actually less need, since the colonial framework in most areas provides for the basics. Although the language may now seem archaic, the original finance laws bequeathed at independence provide much of what might nowadays be considered as the basic principles of democratically accountable budgeting. Together with the country's constitution, the organic finance law typically provides for an annual budget, a deadline for submission, comprehensive coverage, an appropriation process, and a common fund into which all revenues should flow and out of which all payments must be made. These basic laws also provide for the tabling of annual appropriation accounts within a specified period after the end of the financial year, and an external audit process. Such laws also articulate the stewardship role of the finance ministry. While this could be expressed in more modern terms (eg: managing fiscal risks across the public sector), the intent is clear. That this role has been discharged poorly is not due to the lack of a legal framework. Vote holder responsibility (in Anglo terms – the accounting officer concept) is also clearly laid down, but weakly observed. Laws also provide for the office of the Accountant-General, the functions of a treasury and the responsibilities of the Minister and the Treasury Secretary, and the powers to inspect all books of account. If extra-budgetary funds are to be created, prior permission of the legislature must be sought, and annual accounts provided. Supporting these laws are financial regulations issued by the finance minister under statutory powers.

If the issue is that the legislative framework is ignored rather than weak, why the poor compliance?

- Compliance was not always poor. For the first decade or so, continuing long after the departure of expatriates, the basic routines of budgeting and financial management were broadly conducted according to the law and regulations. There was a period after independence when civil servants dominated the political class, which lacked familiarity with the machinery and processes of government, and were reluctant to interfere.
- Deterioration seems to have set in during the crisis of the late 70s/ early 80s, when the trajectories of revenue and spending diverged sharply, staff salaries plummeted, experienced financial management staff left for better jobs in the private or parastatal sectors, the power balance between senior civil servants and ministers shifted, and public financial management standards began to unravel.
- Organic finance laws drafted at the time of independence assumed a parliamentary form of government, but in many countries, constitutions have

been amended to provide for more presidential systems of government. This shift has implications for the power and status of the finance minister, and it alters the relationship between the executive and the legislature.

- For rules to be followed they have to be workable. When budgets become unreliable, managers have to break the rules to achieve politically demanded results. If the finance ministry expects line departments to observe financial regulations, it must deliver budgetary resources reliably.
- Political leaders may prefer “soft” financial management for a variety of reasons. If so, the finance ministry will be discouraged from playing its stewardship role. Its task instead will be to keep the IMF at bay, the donors on side and aid flowing.
- Low salaries and lack of training have taken a toll on financial management. Time was when the Treasury Secretary and the Budget Director were formidable figures, trained in colonial times, and well versed in the existing rules and the principles underpinning them. Nowadays a “good finance ministry man (or woman)” is hard to find. This has been exacerbated in some countries by the de-emphasizing of finance as a career stream, and the “posting” of general administrators in and out of the finance ministry at too rapid a rate to build a true understanding of its functions. Salaries and allowances for key technical staff may be better in the central bank or in major parastatals, draining the finance ministry of key staff.

Nevertheless, there still may be a case for improving the legal and institutional framework for budgeting and financial management. In the first place, traditional organic finance laws, while they provide for key documents like the budget estimates and the annual accounts to be in the public domain, by today’s standards they give insufficient emphasis to transparency. For example, if the IMF’s Code of Fiscal Transparency were to be used as a template, the traditional framework would be found deficient in a number of areas. Most poor country governments are not required to publish the economic assumptions underpinning revenue estimates, fiscal reporting through the year is limited at best, and the medium term implications of spending decisions are not apparent. The publication of annual reports by spending departments and agencies is generally not legislated (though it was a colonial practice carried into the first decade of independence until subsumed into the national planning process), and consequently legislators and the general public have no information on what activities have been undertaken and what results have been achieved. For these and other reasons, governments have been encouraged to update their organic finance laws and regulations.

What are the reasons why countries have moved slowly to overhaul their budget and financial management laws?

- In OECD countries, legal frameworks were changed because governments had reached the performance limits of traditional systems, and rules had to be altered (though not the underlying principles) to allow more productive approaches. By contrast, many poor countries have been performing far below the limits of

existing systems. There is huge scope for improving performance simply by better implementation of existing laws and regulations.

- In a perverse way, the formal rules provide cover for rent-seeking and other financial malpractice. Advances can be given, ostensibly for official purposes, assets can be written off and disposed of privately, contracts awarded corruptly under the pretence of a fair evaluation process.
- Legislating for greater transparency as a way of fostering participation and accountability goes against the grain in countries where a culture of government knows best and the official secrets act determine official attitudes. Many officials do not believe government should be more transparent. And transparency means challenge and greater accountability and also more work. It also means fewer opportunities for rents.
- Seeking greater participation in budget-making may be unrealistic. The time for consultation and participation is when policies are formulated. Mostly, this takes place outside the budget cycle. Making room for it within the budget cycle creates uncertainty. Budget staff are aware of the risks of not getting the budget together in time and fear losing control of the process. Rather than argue for participatory budgeting, donors should be encouraging governments to overhaul the broader policy-making process – ensuring that this takes place within an aggregative resources framework and supports informed collective decision-making.⁵
- If budgeting is more about contesting for resources (between MDAs and MF, and between executive and legislature) for patronage than achievement of agreed goals, a mechanism is needed to hold the ring between contestants, and existing rules do this fine.
- Special skills are needed to overhaul an organic finance law, and poor countries do not have them. International consulting firms pretend they have, but often end up lifting advanced country provisions out of context. Donor agencies lack the knowledge to tell the difference. Local staff quickly lose confidence in external consultants who display ignorance of the existing system.
- Legal draftsmen cannot write new laws in a vacuum, there has to be a clear brief what needs to change and why. This implies a coherent reform strategy, often absent.

Updating organic finance laws and regulations remains desirable. Donors could help by developing better guidance and, perhaps, a model law, assist with workshops and other knowledge sharing activities, and support the preparation of a reform strategy. However, before this is done, donors need to encourage a dialogue on the basic principles of public financial management, involving all relevant stakeholders. They also need to review

⁵ One country which has successfully made budgeting more participatory is Uganda. As part of the MTEF, a system has been established of sector working groups (SWGs), comprising government officials, private sector and civil society representatives and donor stakeholders, who review the implementation of existing sector policies and programs, and provide upstream input into the budget process. Given the heavy aid dependence of Uganda and the need to retain donor confidence, this may be a pragmatic solution, but it raises questions of fundamental sovereignty.

their own practices to ensure these principles are supported by aid modalities, and avoid approaches which increase budget fragmentation.

(ii). Fiscal Sustainability and Responsibility

Virtually all poor countries face fiscal sustainability problems. Sector policies often have medium term spending implications that are unaffordable when considered together. Budgets, in short, are overloaded because governments have made policy and program commitments which cannot be funded in their entirety. This means that policies and programs are often implemented with partial funding only, condemning these programs to intermittent implementation and low efficiency. Poor countries appear caught in a program sustainability trap, unable to fund any program sufficiently because of lack of resources, yet condemned to use existing resources inefficiently for ever.

If this problem is so pervasive, why aren't efforts to resolve it more effective?

- In heavily aided countries, particularly where aid coordination is weak and the domestically funded part of the budget is unreliable, there is a powerful incentive for departments to multiply their projects to capture more donor resources. This is a sound strategy for individual ministries, departments and agencies, but self-defeating for government as a whole. If budget ceilings have no credibility budget making rapidly becomes a bidding process, and aid donors are seen as a more promising source of resources than the Treasury. The more aid on offer, particularly if it comes in the form of project grants, the tougher it is for the finance ministry to retain control over public finances.
- Poor countries operate dual budgets. For reasons explained below, without tight discipline, this form of budgeting can be fiscally expansionary, and thus contributed to the historic over extension of government in poor countries. But as long as countries receive more project aid than budget support, a dual budget is a practical way of managing donor projects.
- Once governments become overextended, calculating the cost of existing policy becomes much more difficult than it is in rich countries, so the exercise is never done.⁶ Consequently, budget makers are flying blind.
- Global pro poor initiatives like the Millennium Development Goals challenge fiscal sustainability by pressing governments to expand areas of spending with high long term recurrent implications. Governments comply not because of their own spending priorities, but because they believe if they expand these programs, aid will increase. PRSPs in theory should encourage stakeholders to prioritize their spending, but this seldom happens, partly because the process, often run by the

⁶ In OECD countries with well developed MTEFs, such as Australia, the cost of existing policy is accurately calculated, and annual budgeting focuses on the "headroom" between this and the available resources envelope. In poor countries the concept of "headroom" is meaningless, since existing policy is seriously underfunded, with inadequate pay and overheads on the one hand, and multiple leakages on the other. Were a poor country to seriously cost existing policy, the results would be unpalatable to both politicians and donors, since some very hard choices would have to be faced.

planning ministry, is not linked to the budget or MTEF, which is run by the finance ministry, and also because budgets anyway are highly inflexible⁷.

- Even rich countries struggle to contain the upward march of spending.

Budget support and donor harmonization of procedures are positive steps. More attention should be paid to building recipient capacity to manage aid programs, both strategically and on an individual donor basis. This would help reduce the “ownership” problem. Just as in former times a well prepared national development plan and PIP provided the foundation for sound aid management, nowadays a well articulated MTEF would assist. Donors on their part need to be circumspect in pressing new goals and initiatives on recipient governments, if this risks pushing the fiscal agenda beyond what can be afforded.

(iii). Budget Coverage and Comprehensiveness

There is concern that off-budget transactions have been increasing in recent years in poor countries. This has come about through revenue earmarking, block grants to autonomous agencies, and aid arrangements which do not pass through the budget. Notwithstanding wording in the organic finance law requiring all receipts to be paid into the consolidated fund and all expenditures made out of it, multiple practices persist which mean that the budget as presented to the legislature gives only a partial picture of public finances.

There are, however, strong incentives for stakeholders to operate in an off-budget manner.

- Some revenue earmarking is driven by donors, who propose earmarking mechanisms to secure funding for the programs they consider high priority.
- Line departments readily comply since they are similarly motivated to operate outside the budget. A weak finance ministry raises no objection because it is afraid of losing donor aid, and sees its primary function to maintain aid flows⁸.

⁷ Conceived as a mechanism to engage stakeholders in the task of making government spending more effective in reducing poverty, the PRSP process in many ways is admirable. But in many countries it has yielded documents which in budgetary terms could best be described as supplementary PIPs – placed before donors at a time when the existing investment project load is too big to implement and too costly to maintain and operate if projects were completed. What should have been a process of priority setting too often has resulted in a “wish list” of needs unrelated to availabilities.

⁸ When the HIPC process began, there was strong donor pressure on governments to create a special “poverty fund” so as to make poverty related spending more visible. Fortunately, governments resisted this, and instead, following the lead of the Uganda PEAP, “virtual poverty funds” were created, by adding a poverty classification to the coding of expenditures. Ironically, it is highly unlikely that any of the donors pressing for a poverty fund could have been aware that in many countries with dual budgets, the organic finance law already provided for a “development fund”, along with, in the financial regulations, the tabling of development estimates, and separate project approval, warranting, release and virement processes. That a line can be drawn between spending that is poverty reducing and spending that is not in practice has led to highly arbitrary distinctions that are pretty meaningless. (See Ghana PER 2004)

- Sector ministry officials have an incentive to create an EBF if government pay scales are deficient, and separate fund status may be parlayed into salary enhancements.
- In countries where politicians have little confidence in the budget to fund their political objectives, they may press for the creation of EBFs, in effect weakening the budget process further. In some countries EBFs have been created to make looting of public monies easier⁹.
- Poor countries often lack a capacity for the cabinet/council of ministers to make decisions in the collective interest, both in terms of ensuring that aggregate fiscal targets are met, but also in ensuring budgets go forward that promote the declared priorities of the government.
- If the finance ministry succeeds in imposing a hard budget constraint in budget preparation, through ministry or sector ceilings, going off budget and getting a donor to finance projects directly is a way for line ministries to escape this discipline.
- Donors, in turn, are likely to protest vehemently if the finance ministry blocks the funding of what in the eyes of the donor is a priority project worked out with a cooperating sector ministry, on the grounds that this would break sector ceilings established under a MTEF¹⁰.
- While PERs carried out under the Bank's leadership may urge the government to make its budget more comprehensive, Bank and bilateral agency project staff seldom, if ever, make the inclusion of the whole project (not just the counterpart funds) in the budget a condition of the loan or grant. In this way donors need to ask themselves whether this practice undermines budget comprehensiveness and transparency, and, in turn, democratic accountability.
- Few, if any, poor countries believe they are in a position to refuse an offer of aid, even if it is in the wrong sector or for a lower priority use.
- When donor funding is outside the budget estimates, it will not be captured in the appropriation accounts.

The Bank and bilateral donors need to acknowledge their own role in the creation of EBFs, and to explicitly make the inclusion of their projects in the published budget a condition of aid. The shift to multi-donor budget support, however, is a very positive development, particularly if it is accompanied by dialogue on budget coverage and the desirability of comprehensiveness. In turn this could lead to support for the decision making processes of government, so that cabinet/council of ministers systems operate better, and ministers face stronger incentives to commit to the collective interest of the government. Changing aid modalities, in turn, could contribute by making the budget as a whole more predictable and credible.

⁹ The most notorious example was the Nigerian Petroleum trust Fund (PTF), created by President Abacha to channel oil revenues into private accounts.

¹⁰ The convention usually adopted is that the budget envelope will stretched to accommodate extra aid if the offer comes on grant terms. Governments which adopt this principle sell short their capacity to manage the aid process.

(iv). Integration of Recurrent and Investment Budgets

Low income countries, in contrast to developed ones, almost without exception have dual budgets. These can be traced back to the era of national development planning and a paradigm of development which held that nothing would happen by markets alone, and governments had to intervene. One of the principal means of intervention was capital spending, and it was widely held that public investment was a superior form of spending to current outlays. Indeed, in the early days before structural adjustment, a budget strategy widely pursued was to deliberately restrict recurrent spending so as to maximize the quantity of local resources to apply as counterpart funds to aid financed capital projects. The more the recurrent budget could be squeezed to release domestic resources to meet local cost requirements of donor funded projects (particularly IFIs), the greater the chances of increasing overall aid flows¹¹.

Agencies like the Bank and the Fund have been advising governments to integrate their two budgets, either by fusing them into a single budget or by ensure that operating costs are better funded, and as projects are completed, their operating costs are provided for. We have also argued for budgets to be more comprehensive. There are good reasons for seeking a better balance between the two categories of spending and more inclusive budgeting. Country after country offers the spectacle of departments unable to operate current services while at the same time pressing forward with new investment schemes to expand the very services they are currently unable to run properly¹².

Over time the investment budget is transmogrified into a substitute current budget as donor agencies build running costs in to the projects they finance. In poor countries nowadays, the so called investment or development budget contains hybrid projects, blending new capital investment with delayed maintenance and running costs of new and existing services. This makes it difficult to see a return to the days of national development plans when there was a clear cut distinction between the two budgets and a rigorous analysis of the incremental recurrent costs of new capital spending proposals was a criterion for their acceptance into the PIP and the budget. Against this background, the advice to integrate the two budgets and seek a balance between running costs of existing services and new capital for their expansion seems eminently sensible.

Why does this not happen? There are many reasons for the slow implementation of such practical advice:

- Many countries still retain separate organizational structures for the recurrent and capital budgets, dating back to the days when governments produced national

¹¹ Nowadays, donors are less concerned with counterpart contributions, and the rules for IFIs have been progressively relaxed. The “local cost” problem was a pressing issue for both governments and donors in the 1960s and 70s.

¹² This leads to bizarre economic results. New roads projects deemed viable *ex ante* show *ex post* returns plummeting if maintenance is delayed. Road surfaces collapse undermining foundations, in turn driving up vehicle operating costs to levels which make the return on rehabilitation (assuming maintenance is restored) a multiple of the original rate of return. A road project with a rate of return of 100% is a telltale of a previous investment collapsed.

plans, and a planning ministry or national planning commission was mandated to prepare the capital budget. The organizational cultures of planning and finance ministries were almost invariably at odds, and even though national plans are no longer produced in many countries, the institutional rivalries (and the separate budget preparation responsibilities) persist.

- In poor countries recurrent budgets are mostly locally financed, and overhead funding is unreliable, being vulnerable both to across the board cuts in budget preparation and shortfalls in cash releases. Capital projects are largely donor financed, and their funding is more assured. In high aid inflow poor countries departmental budget makers load capital budgets with running costs because the chances of funding are higher, rather than seek higher overhead provision only to see their requests cut. The domestic budget is mainly a wage bill budget, the real budget is the aid budget.
- For the same reason donors have come to prefer funding running costs within capital projects, because they, too, have little faith in provision through the domestic budget. There are strong incentives for donor agency staff to ensure their projects are implemented as intended, and insulating projects from the risks of a dysfunctional local budget process achieves this¹³.
- The more running costs can be incorporated into donor funded capital projects, the greater the expectation of “perks” such as overseas travel, donor allowances and training for staff working on these programs. The relative value of this increases if civil service pay scales have collapsed or payrolls are in arrears.
- Departments also like capital budgets because once the point has been reached where donors dominate capital budget funding, the chances of obtaining finance rise relative to the non-wage components of the domestically financed recurrent budget.
- In many countries the rules for the capital budget are more flexible than those of the recurrent - unused approvals may be carried forward to the next year. Once a project is established in the capital budget, it is very difficult to remove it, however slow its implementation. And in many countries, virement rules are easier for the capital budget (though shifts may require donor approval).
- If the budget is not comprehensive, and the finance ministry’s grip on aid coordination is weak, departments can exploit the extra-budgetary character of aid to circumvent centrally imposed budget ceilings.
- The scope for rents is generally larger in capital budget spending, simply because more contracting is involved (though there may be employment patronage possibilities through the recurrent budget). Donor procurement rules, such as the Bank’s, are only a partial defense.
- Departments may initiate capital projects to lever greater recurrent funding later. Build more schools and the finance ministry will be forced to fund the salaries of more teachers.

¹³ The Bank’s rule (OP 6.0) that recurrent costs may be financed as part of a project on the assumption that the government will be able to meet these costs later is self deception. If the government cannot allocate enough funds to meet recurrent costs during the capital phase of the project, when typically they are lower, it is unlikely to meet them later.

- Politicians prefer capital over current spending because the first creates physical assets they can show constituents (even if they know services will not be provided), the second simply disappears into a bureaucratic machine they do not trust.
- The traditional methodology of calculating the incremental recurrent costs of projects during project preparation has long since been abandoned, not least by donors who have taken over responsibility for project preparation from recipients.¹⁴
- The old paradigm of the superiority of public investment spending over current spending still retains a grip over budget-makers' minds. Even if donors were to withdraw, governments to the extent they could would still give priority to new capital spending over maintaining existing assets and running current services.

The Bank and bilateral donors could usefully give a lead once again by taking the incremental recurrent costs of the projects they finance seriously. They should continually emphasize in the dialogue with governments the need to fund existing policy adequately before investing in new capital assets. Fortunately the progressive shift to budget support should help integrate better the two budgets. It will also reduce the project bias arising from traditional aid modalities.

(v) Budget Documents: Transparency and Classification Systems.

While rich countries have made great strides in recent decades in making budget documents more accessible to both legislators and the general public, in many poor countries the layout of the budget has changed little, and past efforts to introduce new formats have as often as not been unsuccessful¹⁵. This applies to both the detailed budget classification systems adopted and the overall layout of the budget estimates and the amount of useful information they convey, though possibly a little more progress has been made with the former.

Why has reform in this area been so slow, and what are the relevant stakeholder incentives?

¹⁴ Donors would do well to remember that in the days of national planning, many governments did produce sector programs and PIPs, and maintained an internal process of project preparation. In poor countries too often donors no longer comes in to appraise and finance a project whose main parameters have already been worked out by local planning staff. Rather, donors substantially prepare projects and appraises their own work. Local ownership of the process much of the time is a veneer. And the appearance of local ownership may too easily be secured by buying the time of officials with *per diems* and other perks. These are disproportionately attractive when local pay scales have collapsed.

¹⁵ Discerning students of budget documents, like archaeologists digging up past civilizations, will often see in the budget documents of poor countries the evidence of previous attempts to reform budget classification and layout systems. Recurrent budgets may be notionally classified by program, but in reality estimated are arranged by organizational units. Capital budgets may have a column headed "targets", but the narrative given is about expected purchases and activities.

- Changes in the budget documents are usually the consequence of initiatives to introduce a new system of budgeting, such as program or performance budgeting. Their durability is a function of the success or failure of the new budget system.
- Budget systems revert to their “default” setting – in this case line item input oriented dual budgeting - if the overall reform endeavour fails. Traditional budgets have overriding residual advantage – they are simple, staff are familiar with their routines, and if there is no performance culture in government, a focus on inputs suits everyone.
- If the country already has a separate planning agency, it will resist any change in budget systems which do away with the separate presentation of projects – since this diminishes their organizational importance.
- If there is no performance culture in the government, there will be little demand for more sophisticated classification systems, since no one will be interested in analyzing the information they can provide. Classification systems modernized at the behest of donors generally stick because they are embedded in the chart of accounts. But the analytical potential is seldom realized.
- More transparent budget documents provoke greater debate on the budget in the media and parliament.¹⁶ While this increases accountability, civil servants prefer a scrutiny process that focuses on the *minutiae* of the budget estimates, rather than strategic allocations.

Donors should do a lot more to encourage governments to make their budget documents more transparent. If the organic finance law is being re-drafted, it should include clauses on transparency. Once transparency standards are enacted, donors should make observance a condition of their aid.

(vi). Budget Preparation Timetable

Studies of poor countries’ public expenditure management practices often recommend lengthening the budget timetable to allow more time for consultation, preparation, submission and consideration of the budget estimates. Typically the time for budget preparation within MDAs is limited, discouraging reconsideration of existing allocations. This reinforces incrementalism. There is no time to apply the lessons of evaluation, even if this has taken place, and thus it makes no contribution to budget making. There is also no time for consultation and this beneficiary concerns are seldom reflected. In many countries the new financial year starts without an approved budget in place, obliging the government to resort regularly to contingency provisions, typically based on last year’s approvals. While this does not affect current budget implementation greatly, it delays the start of capital projects, particularly the ability of departments to begin contracting. This in turn perpetuates a cycle of never completing project work plans, and is one of the reasons for the structural underspending of the capital budget. In

¹⁶ A decade ago Kenya introduced a popular summary of the budget, at the same time the main budget was being debated. This short but well done document showed clearly how 90% of the education budget was going to salaries, to the detriment of classroom maintenance and materials. This provoked a healthy debate, which in the end led to improvements in the ratio between wages and overheads.

a more fundamental sense it undermines democratic accountability, forcing the legislature to retrospectively approve spending that has already begun.

The usual prescription of the Bank and the Fund is to lengthen the budget preparation cycle, starting the process several months' earlier. Some countries have been able to do this, but in the main call circulars still go out late, and much of the first quarter of the new financial year is taken up with legislative review and approval of the new budget. As a result, the passage of the appropriation law takes place only several months after the start of the new financial year. While most countries' finance laws have contingency provisions allowing spending to continue at last year's levels, while this allows the current budget to continue, capital budget projects, particularly if they are new ones, are delayed. Delay in budget approval, furthermore, plays havoc with orderly procurement planning.

What inhibits the adoption of a more timely and orderly budget preparation timetable?

- Budget offices have to implement the current year's budget as well as prepare the next one. Much of the first part of the year is spent authorizing spending on the current year's budget, and there is little spare time to think about the following year's budget. This causation is even stronger if the current year budget has been delayed, and budget office staff are still busy incorporating changes to the approved budget and issuing spending warrants. It may be mid-year before the budget office is ready to think about the calendar for the next financial year's budget preparation. Budget staff may see a trade-off – spending time on ensuring the existing year's budget is being implemented smoothly, versus investing in a more thorough budget preparation process for next year. In a setting where resource allocation is controlled and monitored closely from the centre (perhaps to ensure compliance with a Fund program), the short term requirement to control the present year's budget will trump getting next year's call circular out early.
- When international agencies ask governments to lengthen the budget preparation timetable, they usually also ask them to add stages to the process, such as the development of a fiscal strategy, publication of a medium term expenditure strategy, consultation with stakeholders, briefing of the legislature etc. However desirable these additional features, there may be no capacity to execute them.
- If they are weak, budget office staff will feel more comfortable with the familiar routines of line item incremental budgeting, with the budget office cutting back excess demands of spending ministries. This sort of budgeting requires less time, and both sides know what is expected of them. By contrast, a deeper examination of current and capital spending is both a time consuming and conflictual process.
- They may also prefer traditional budgeting for rent seeking reasons. A budget which is prepared in a short space of time and cannot be implemented as passed (because it is too large) necessitates selective release of cash, in turn creating opportunities to extract rents.¹⁷

¹⁷ If line ministry staff are manipulating the procurement process to extract rents for themselves, they will be prepared to share those rents with budget office staff in return for the release of funds for current budget

- If a country lacks skilled macroeconomists, it is difficult to make accurate forecasts of next year's revenues until the current year is sufficiently advanced so that collection trends can be observed. Revenue agencies are more comfortable predicting next year's collections once the mid-point of the current year has passed.
- It is straightforward to re-issue last year's call circular, with a few changes in the numbers. It is more challenging to begin the process with a fiscal strategy paper.

Before recommending a lengthening of the budget preparation cycle, the Bank and other donors should assess the capacity of the budget department, and provide assistance if this is needed. Seeking a lengthening of the budget preparation process, while generally desirable, implies extra work, and capacity must be built at the same time to handle a lengthened budget preparation timetable.

3. Budget Implementation

(i). Cash Budgetting

Donors have many concerns over the way the budget, once approved, is implemented. PERs and CFAAs point out that budgets are seldom implemented as planned, but curtailed by the imposition of "cash limits". The critical mechanism is the cash release system of the Treasury. Instead of releasing money at regular and predictable intervals, cash is forthcoming only when the Treasury is sufficiently liquid. Typically, a small committee comprising the Accountant-General and other senior Ministry of Finance officials meet weekly to review the most urgent claims on government resources, releasing funds as available, in a priority order that places statutory charges such as debt servicing ahead of voted expenses, the wage bill ahead of pensions, and both ahead of non-wage operations and maintenance expenditures. On the capital side, funds are released selectively, to projects that the President has deemed politically important, to projects that require a local cost contribution to secure aid disbursements, and to meet pressing arrears and keep a contractor on site. When this happens, the approved budget simply becomes a legislatively approved set of upper limits for spending, a shell within which the executive makes decisions on what should be given and what denied funds in a non-transparent manner. A different sort of dual budget emerges: the real recurrent budget is the cash release budget, the real capital budget is aid disbursements.

The conventional prescription for remedying this state of affairs is, first, to make more realistic budgets in the first place – ones that can be financed by domestic resources, and, second, to institute a better cash management system. The first is likely to mean making budgets within a medium term fiscal framework. The second entails setting up a cash flow management unit in the Treasury, strengthening the capacity of the

procurement or capital budget project contracting. Budget dependent agencies seeking, say, a quarterly release of funds in some countries routinely have to bribe parent ministry or budget office staff to obtain cash release. Traditional budgeting, based on detailed control over release of funds, facilitates this.

finance ministry to make fiscal forecasts, gathering information on the likely monthly flows of revenues and the distribution through the year of different categories of spending, and preparing a domestic financing plan, based on short term local borrowing and treasury bill issues, consistent with monetary policy objectives. It may also entail the closure of multiple MDA bank accounts and the installation of a single treasury account (TSA), and the tightening of fiscal reporting systems.

How is it, then, that this eminently practical advice is either not followed, or if taken, succeeds only temporarily, until cash budgeting reappears?

- The finance ministry may not have the technical capacity to make realistic fiscal projections, due to the loss of key staff.
- IFI pressure on a country to achieve fiscal targets (level 1) combined with the PRSP process (level 2) may make cash budgeting inevitable, if existing spending patterns are not flexible and the government lacks strong budget institutions.
- If the rest of government, including the President, sees the role of the finance ministry to be “finding the money”, the latter may not have the political power to impose realistic budgets on the spending ministries. It will therefore seek to impose the budget it wants second time around, through cash budgeting.
- In a fundamental sense, the government may balk at the discipline of subjecting spending to an annual plan, and prefers instead a budget system which is responsive to day-to-day political needs.
- In some countries where the legislature has the power to change the executive’s budget, it may add spending which cannot be financed.¹⁸
- The finance ministry may not trust line ministries and agencies to spend according to the published budget, and prefers to control spending on a month-by-month and more selective basis.
- Cash budgeting creates rents for those who control the process and enhances their power. Bribes paid by contractors to ensure release of funds for a major project may be shared between the line ministry and ministry of finance officials.
- An effective cash flow management system require good fiscal reporting, which line ministries may not comply with, and the finance ministry may not be prepared for the political conflict arising from denying a ministry funds.¹⁹

¹⁸ This has happened on a regular basis since the return to democracy in Nigeria, whose constitution follows the US rather than the UK model in the allocation of budgeting powers. Each year the executive has presented a broadly affordable budget to the National Assembly, only to have the latter add substantial amounts of capital spending (and the expansion of the legislature’s own vote). The threat to veto an unaffordable appropriations law has been countered by impeachment initiatives, leaving the executive with no alternative but to implement the budget through the cash release system. In turn this has led to the introduction of legislation to curb the President’s impoundment powers. To break away from this sterile habit, the FMoF now proposes to introduce a MTEF and share it each year with the National Assembly ahead of detailed budget preparation, in an effort to get legislators to understand and support the government’s fiscal strategy.

¹⁹ Under most countries’ organic finance law, the finance ministry has the power to deny funds to a ministry which fails to report, and to sanction the vote holder. But the use of this power is likely to be the outcome of political, not legal considerations.

- Closing multiple ministerial bank accounts and imposing a TSA will be resisted by line ministries, since it entails a shift in power, and the tightening of controls. Line ministry finance directors may be receiving commissions for depositing cash in interest free account in banks that otherwise would be illiquid.

IFIs and bilateral donors need to consider the pressures they are imposing on country budget systems through fiscal targets and poverty reduction goals in relation to the capacity of budget systems to meet re-allocation decisions, and to balance this with untied budget support, and assistance for public service reform, to the extent possible.

(ii). Fiscal reporting

The financial regulations for public financial management in many poor countries require ministries, departments and agencies to report regularly to the finance ministry on budget execution. There may also be requirements in law for a summary of this information to be published, say, on a monthly or quarterly basis. Reporting to the finance ministry (or specifically, the Accountant-General and the budget director, provides information needed for the finance ministry to manage the budget, the treasury and public finances generally. Publishing summaries of this information contributes to democratic accountability, by keeping the legislature, media and general public informed about public finances.

Bank (and Fund) advice to governments stresses the important of timely fiscal reporting, and technical recommendations may be given to improve the processes of collecting and transmitting the required information. Fiscal reporting, nevertheless, remains an area where performance continues to fall short of what is desirable. Why is this so, and what are the incentives in favour and against regular fiscal reporting?

- Ministries may face genuine technical problems transferring data from decentralized offices, and collating them in ministry headquarters before transferring them to the finance ministry. Telecommunications are often a bottleneck due to lack of investment, over the years, in equipment and networks.
- There may be lack of competent budget and accounting staff in ministries, which are thus unable to furnish the reports on time. In turn this may be due to low salaries and demotivating working conditions.
- If a cash budget operates and there is no predictable release of funds, ministries may feel there is little to be gained from regular fiscal reporting.
- The finance ministry has legal powers to hold back funding for a ministry if it does not furnish timely reports, consistent with its stewardship function of managing fiscal risks. However it often chooses not to exercise them partly because this would be an extreme step (equivalent to closing down part of the government) for which presidential backing might not be forthcoming, and partly because in a cash budgeting situation it is itself unable to live up to the implicit contract of the budget – that funds will be provided to line ministries to implement what has been agreed in the budget.

- Donors are only recently emphasizing fiscal reporting. For years the pre-occupation of donors has been on budget allocation rather than how it has been implemented.
- Parliaments, too, have a similar bias, focusing on what's in the budget (often parochially, from a constituency standpoint), rather than how it is implemented.

IFIs and donors should help countries solve technical bottlenecks to timely fiscal reporting, review reporting standards, and then with budget support/HIPC conditionality stiffen the finance ministry's resolve to demand better reporting from MDAs, even if this means withholding monthly allocations. The positive gain is the potential for civil society pressure on government for better performance.

(iii). Procurement

In recent years, the Bank has extensively surveyed the performance of poor country governments in procuring goods, works and services, by undertaking Country Procurement Assessment Reviews (CPARs). These reviews generally find that the legal framework is weak, that the tender board system operates badly, that tendering is uncompetitive and rushed, and that in some countries contracts are routinely given to firms that bid higher than the lowest evaluated one. Few ministries, departments or agencies prepare procurement plans, standard bidding documents are often not available, or deficient, technical procurement skills are in short supply, and there is no clear appeals channels for bidders who are aggrieved with the process. Abuses also occur during contract management.

The Bank's diagnostic instrument, the CPAR, dispenses a standard prescription: (i) enactment of an UNCITRAL type procurement law, (ii) abolition of the central tender board, shifting all procurement responsibility to officials in line ministries, (iii) creation of an autonomous procurement regulator, whose task it is to set the rules, monitor performance, and hear appeals. Recommendations may also be given to create a professional cadre of procurement staff, to standardize bidding documents, and to improve the transparency of the process.

A second round of CPARs is now being launched, essentially to ascertain what progress has been made implementing these recommendations. This is likely to show that while there has been activity, existing practices in many countries are largely unchanged, and procurement has not become more competitive and less fraud prone.

What are the incentives for reform, and what are the sources of resistance?

- Public procurement is a natural target for rent seekers, particularly so in poor countries where officials are badly paid and politicians manipulate government contracts to reimburse election expenses, dispense patronage and acquire wealth.
- Procurement reforms seek to entrench rule bound and transparent processes, which limit the discretion of public officials and make their decisions more open

- to challenge. Even if officials are honest, there will still be bureaucratic resistance.
- In countries where procurement is seen as a specialized application of financial management, there may be resistance to taking responsibility for this away from the finance ministry and locating rule setting with an autonomous procurement regulator. Arguable, overseeing procurement is part of the finance ministry's stewardship function.
 - Central tender boards traditionally deal with contracts regarded as too large for individual ministries to award alone. Reasonably, the view may be taken that line ministries lack the capacity to manage large procurements, and that the fiscal risk involved requires direct central involvement in the process, not just regulation. Heads of government may want to retain control over major contracting ventures, the success of which is important politically.
 - Decentralizing procurement means decentralizing significant authority. If budget holders are not held accountable for financial management overall, their conduct of public procurement will also be at risk.
 - If rents are a major factor in procurement decisions, large contract awards will be retained centrally, to ensure funds generated are available for political purposes, rather than dissipated to line ministry civil servants.
 - Ministers in line ministries may, for the same reasons, resist ceding control of procurement to officials.
 - If, due to cash budgeting, releases to spending agencies during the financial year are unpredictable, they will be discouraged from undertaking procurement planning.²⁰ (Conversely, absence of procurement planning undermines efforts by the finance ministry to improve cash management and develop a robust MTEF).

Set against these powerful incentives to maintain the *status quo* are some reasons for optimism.

- With the shift to budget support, coupled with the close monitoring of government financial management systems under HIPC, governments increasingly are recognizing that they need to implement procurement reform to retain the confidence of donors, and increase the share of aid that is untied to projects and disbursed into the Consolidated Fund.
- As democratic institutions deepen, countries can reasonably be expected to graduate from a political system which secures re-election by the distribution of patronage, to one in which voters return a government on the basis of results in delivering services. This means governments have a political incentive to improve procurement outcomes.

The current focus by donors on more open, transparent and competitive public procurement process for goods, works and service contracts is very welcome, and should continued by donors. However, there is a need to review the suitability of "one size fits

²⁰ This is a vicious circle: absence of procurement planning by the major spending ministries undermines the efforts of the treasury to both improve cash management and develop a well functioning MTEF.

all” procurement reform recommendations, and allow greater flexibility in implementation. An alternative to an Uncitral type law would be the inclusion of procurement principles and key processes in a revised organic finance law. If a procurement regulator is to be established, the default location should be under the Ministry of Finance. And greater attention should be paid to the sequencing of procurement reforms, avoiding an “all at once” approach to what needs to be done.

(iv). Internal Audit

Internal audit staff can be found in most poor countries’ governments, but they are low skilled and relegated to voucher checking tasks. Few, anyway, would be capable of assessing the functioning of control systems and advising the head of the ministry or agency. In some countries there may be an internal audit cadre, headed by a Director of Internal Audit (or the Accountant-General), who supervises their professional development, and posts them to line ministries. This system is supposed to give them some professional independence, and enable them to “speak truth unto power” in the ministries where they work.

CFAAs have drawn donors’ attention to the internal audit function, and increasingly efforts are being made to enhance the function. Typically, these entail providing training, encouraging staff to join a professional organization, and reviewing legal, organizational and reporting arrangements²¹

What stands in the way of countries creating an effective internal audit capacity?

- Pay remains an obstacle in many countries, particularly if internal auditing is seen for what it should be – an assessment of the adequacy of control systems. Internal auditors need not only a sound knowledge of government financial management, but also an ability to look at the performance of systems as a whole. People who have these skills command good salaries in the private sector.
- Internal audit works only if there is demand for the services that an internal auditor can provide. This does not exist in many poor countries, where lax financial management is tolerated and the head of a department (or accounting officer) is not sanctioned for poor management of the vote.
- Some heads of department have a vested interest in a weak internal audit capacity. They do not want control systems to be effective, since they are complicit in fraud.
- In “soft” financial management systems, the incentives are against internal auditors rocking the boat. They will be thus content to undertake routine voucher checking functions.

²¹ Sometimes with reform taking an unusual course. In Malawi the internal audit cadre, in a false analogy with the private sector which ignores the role of the finance ministry, is being transferred to the Office of the President. In Ghana a law is being passed creating, in a curious distortion of the concept, an autonomous agency for internal audit.

- Training and membership of a professional association will be welcomed primarily for the prestige they convey, not for the acquisition of skills for better job effectiveness.
- Until recently, donors have largely ignored the role of internal audit, and have done little to build capacity.

The Bank and bilateral donors should support the strengthening of internal audit, but in doing this they should appreciate that this is primarily a demand, not a supply side, challenge. Internal audit will gain stature only when vote holders are accountable for how they use budget resources, and budget support and HIPC conditionality should reflect this. Organizational reporting structures for internal audit should be consistent with the stewardship role of the ministry of finance. With the shift to multi-donor budget support, development partners are in a better position to raise the condition of internal audit in the dialogue, and exert some of the demand side pressure which hitherto has been absent.

(v) Accounting

For several decades government accounting systems were neglected by both governments and donors, and the necessary investments in staff training, systems modernization and equipment did not take place. In many countries this led to several years' backlog in the production of annual appropriation accounts. Donors mostly ignored this, since their focus was the projects they were financing, for which separate accounting arrangements operated. Governments did as well, since many were authoritarian regimes, and the legislature, if it existed, tolerated the absence of accounting. Now with the return to democracy across the Region and the reactivation of parliamentary committees, there is a domestic demand for timely accounts, as statutorily and constitutionally required. At the same time the IFIs and bilateral donors, through the shift to budget support and the HIPC process, are taking an interest in the capacity of governments to produce timely and accurate accounting reports, both from the perspective of better financial management by government, and also for democratic accountability.

In CFAAs and other diagnostic reports, the Bank has therefore been urging governments to modernize their accounting systems and end the backlog in accounts. Generally, this has been happening, but difficulties have been encountered on the technical front, and modernization is proving both costly and time consuming.

What are the institutional and individual incentive issues at work?

- While there was some donor support for accounts modernization in the past, donors generally ignored the failure of governments to render accounts at the end of the financial year, as required by law. This sent a signal to governments that, as far as aid flows were concerned, timely government accounts did not matter, only project accounts.

- The principal source of pressure during this time was the IMF, but the emphasis here was on accounting information to track the fiscal aggregates, not for democratic accountability.
- Until the advent of budget support and HIPC, many donor staff were unaware of the statutory requirement for appropriation accounts, and thus never raised it in the dialogue.
- Donors have not built up sufficient in house knowledge of public sector accounting modernization to authoritatively advise governments.
- Governments lack this knowledge also, and are easy prey to aggressive marketing by software providers and systems integrators. There is a bias towards over-specifying systems.
- Erosion of salaries has meant that accounting departments are unable to recruit, retain and motivate the professionals they need.
- Political leaders have seldom been interested in timely government accounts, and when vote holders are not held accountable, there is little interest in either accounting information for management or for democratic accountability at the end of the year.
- Instead of reporting to the legislature that no accounts have been received for audit within the statutory time period, SAIs have sat back and waited, sometimes many years.

The important challenges for the Bank and donors now are to act on both the supply and demand side of accounting modernization. To support the supply side, the Bank needs to build up its technical knowledge and distill lessons from the experience of other countries on approaches and sequencing, and continue to be prepared to finance installation of new systems and the training of staff. On the demand side, it needs to continue to put pressure on governments to come current with annual accounts, monitoring progress through the HIPC/AAP process and with CFAA updates, eventually making the timely production of accounts a basic aid conditionality.

4. Auditing and Legislative Review

(i). External Audit

The model bequeathed at independence for both Anglophone and Francophone countries provided for an external audit process. In the case of the first group the Supreme Audit Institution (SAI) took the form of a constitutional officer – the Auditor-General, protected from arbitrary dismissal and with his salary statutory (i.e. non-voted) expenditure. In the case of the second group, a *Chambre* or *Cours des Comptes* was established as a branch of the judiciary. The main task of the Auditor-General was to ensure that spending followed the rules and the appropriation accounts were a true record of how the budget was spent.

This system collapsed into ineffectuality in many countries for a variety of reasons. First, there were delays in the production of accounts to audit. Second, under

military rule parliamentary committees set up to receive and hold hearings on the Auditor-general's report were disbanded. Third, as civil service salaries dwindled, the SAI, never well endowed with professional staff, lost those with skills transferable to the private sector.

Fourth, budgets were squeezed, leaving the SAI with little more than a salaries vote, with no capacity to install modern office technology, send staff on training, visit project sites, or high outside consultants to undertake specialist assignments. Most important of all, finance ministries, traditional allies of the SAI, began to forget their stewardship function, and there was little follow-up of audit findings, either during the year or after the annual report had been tabled.

More recently, there have been efforts in several countries to catch up with annual audited accounts, spurred by donor conditionality under HIPC and by pressure from newly elected legislatures. Yet the external audit process overall remains ineffective.

In such circumstances CFAAs usually recommend the passage of a new audit bill, enhancing the independence of the Auditor-General.²² The new laws passed have sought to give the Auditor-General greater power over his budget and personnel. A common formulation is that the Auditor-General prepares his own budget, and passes it to the Minister of Finance, who must then transmit it, as part of their Estimates, to the legislature without change. The Minister may, however, comment on the appropriateness of the budget if he so chooses. The Auditor-General may also be given greater control over his own personnel, setting salaries and recruiting his own staff. Here he may be guided by an oversight body of eminent persons, including representatives of the private sector profession. He may be given powers to carry out "value for money" audits, and to submit reports on any matter during the year, rather than wait until year's end.

In contrast to other FM reforms, this is one that is usually warmly embraced, at least by the Auditor-General and his staff. Whether this will lead to improvements in audit remains to be seen. The following are some reasons why results may be different to expected.

- Unless there is a commensurate speeding up of the preparation of the annual accounts, the completion of the audit will still be delayed beyond the statutory limit.
- Independent preparation and submission of budgets may make little difference if the finance ministry still operates a cash budget, and restricts releases to the SAI to salaries alone.
- The Auditor-General and his staff may choose not to make use of their enhanced independence, and confine their critical observations to minor irregularities. They

²² Under the traditional system in Anglophone countries, the Auditor-General's roles and functions was normally covered by the organic finance act - often called *Finance and Audit Act*. There was nothing inherently disadvantageous in this - the Auditor-General's responsibilities and powers of search can be covered just as easily in a joint law as well as a separate one.

may deliberately avoid investigating areas of greatest fiscal risk.²³ Few Auditors-General are crusaders, most simply want a comfortable life and elite acceptance, and their reports are aimed at demonstrating that the audit is being performed, but no big boats are being rocked.

- The SAI in Anglophone countries is a watchdog, with no direct powers of sanction. He depends on the finance ministry to follow-up with disciplinary actions, but this seldom happens in a “soft” financial management environment.
- Aid donors, including the Bank, have unwittingly undermined poor countries’ external audit institutions by never raising audit findings in the context of individual project preparation, and portfolio discussions generally. By continuing to provide aid regardless of government wide audit findings, donors have helped marginalize the SAI.

In supporting the strengthening of external audit institutions, the Bank and bilateral donors should give equal emphasis to the follow up of audit findings by the executive, and emphasize in dialogue the key role of the finance ministry in managing fiscal risks. Staff preparing sector investment projects should raise with counterparts recent audit findings and action taken.

(ii). Parliamentary Scrutiny

The return to democracy in most poor countries has led to the reactivation of parliamentary committees which scrutinize public spending, both *ex ante* and *ex post*. Donors on their part (the WBI has been particularly active) have provided training for members of parliamentary committees, and provided an opportunity for parliamentarians from poor countries to meet and exchange experience with those from richer countries. In many countries media attention to the findings of, say, the Public Accounts Committee, has been striking.

A critical issue in countries whose basic finance laws derived from parliamentary models is whether the legislature should have the power to change the executive’s budget. It costs money to be elected an MP in poor countries, and understandably parliamentarians feel frustrated faced with a budget they find difficult to comprehend and have little faith will be implemented as approved. Not unexpectedly, they seek to change the executive’s budget to better reflect their political constituencies. When it has been given, Bank advice generally has been to constrain the ability of the legislature to change the budget with a hard budget constraint - the legislature may only add new spending if it diminishes spending somewhere else in the budget, so that the overall effect is fiscally neutral. Bank staff have also urged legislature to focus not on changing the budget, but in scrutinizing how the executive implements its budget.

Another issue is whether the Public Accounts Committee (in Anglophone settings) should have sanction powers.

²³ Logically, the Auditor-General would want to look closely at government contracts, an area where government procedures are very vulnerable to manipulation, and large sums stolen, but few in poor countries do this.

The following are some of the institutional and individual incentives driving stakeholder behaviour.

- The capacity of committee members to effectively scrutinize budgets and accounts is limited. Skills build up over time, and will be brought to the task if the committee person is a professional accountant. Few are, and the rest have yet to build an understanding of government finances.
- Their concerns are parochial, causing them to focus on projects that affect their constituencies, and they may ignore the larger fiscal risks of spending plans which are not location specific may present.
- Parliamentarians have to generate substantial amounts of cash to retain their seats in the next election. Some choose to go along with the government in order to receive benefits. A parliamentarian who is deeply critical of government waste will find it difficult to raise the resources needed to fight the next election.
- Both budget estimates and annual accounts are difficult to read documents, and parliamentarians may be condemned to futility because they lack the skills to understand the documents.
- If the finance ministry is unresponsive to audit findings, the PAC will be unable to get the executive to take follow up action on PAC recommendations.
- The media in many countries are unable to sustain a story such as the PAC more than a few days, and many of their readers find their stories confirmation of what they believe government to be, rather than a call for action.

The Bank and bilateral donors should continue their efforts to strengthen the capacity of parliamentary committees. In so doing, they should put pressure on governments to improve the transparency of budget documents and the timeliness of annual accounts. As with external audit, they should also emphasize executive follow up.

5. Conclusions - The Way Forward

The aim of this paper has been not just to catalog the areas where countries may be unable to implement reforms as fast as the donor community wishes, but to suggest some of the underlying reasons. The reasons are partly technical, but for the most part they are about stakeholder incentives. Many of these incentives favour maintaining the *status quo*. This, in turn, explains the surprising stability of poor country ways of managing personnel and financial resources. Other incentives derive from the aid process itself. These have long been ignored by the Bank and bilateral donors, and while there has been some recognition in recent years and efforts made to remedy negative effects, in broad terms much more needs to be done to understand the influence of the aid process on counterpart responses, and to confront and change donor policies and processes when they are shown to be negative. Overall, the paper's position is that aid has become the dominant factor in poor country budgeting, and thus there is a need to candidly assess both the positive and negative impacts of this relationship on public financial management, and to make changes.

The outlook is generally a positive one. Great strides are being made through the HIPC/AAP process in understanding poor country financial management systems, and making their performance a central part of the dialogue. At the same time, there is no room for complacency, since donor initiatives, notwithstanding good intentions, can continue to undermine country efforts to rebuild strong public financial management systems.

Donors, however, need to see the demands they make on government financial management systems not only from the perspective of their own projects, but how what is being demanded affects local budget and financial management system.²⁴ This question is not asked sufficiently often. Thus the starting point for donors is to gain a deeper understanding of both the incentive effects of their aid and how this interacts with the underlying governance conditions within a country, from which public financial management can never be separated.

There is also a need to understand and map the incentives of the main stakeholder of any PFM reform process. Mapping incentives means getting closer to counterparts and seeking to understand the problems from their perspective. Tools, such as short questionnaires, need to be developed to help donor staff understand the informal incentives facing counterpart staff in poor countries. More work needs to be done to elaborate such approaches. As a picture builds up, both Bank and bilateral agency staff should gain insights into the environment in which government counterparts work, and discover ways of reshaping incentives through both their project interventions and through greater recourse to multi-donor budget support instruments such as PRSCs and SWAPs, and thus changing behaviour and reducing resistance to public financial management reform.

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²⁴ A case in point is the PRSP process, which has been effective in signaling that donors want governments to focus their spending better on poverty reduction, but disruptive of budgeting, in that PRSP documents have tended to be wish lists of capital projects which, even if they could be financed, would languish for lack of operating costs.