CHAPTER 2

THE LEGAL AND INSTITUTIONAL FRAMEWORK

Effective budget management begins with a clear distribution of responsibilities and duties within the government, and between the different levels of government, and a carefully balanced division of powers between the parliament and the executive branch of government. For this purpose, the legal framework must be properly designed. This chapter reviews the broad principles concerning the distribution of responsibilities within the executive, the role of the legislature, the relationships between the different levels of government, and the major provisions that should be stipulated in the legal framework.

A. Distribution of Responsibilities within the Executive

1. Authority of the ministry of finance

Ministries of finance are responsible for the custody and management of all public money. To be effective as the guardian of the collective fiscal integrity of government, the ministry of finance must be sufficiently empowered through the necessary legal and technical instruments, and have staff with the required skills and training. Ministries of finance have generally extensive powers in OECD countries. In some developing countries and medium-income economies, finance ministries are also powerful institutions that sometimes misuse their authority by interfering excessively in line ministries’ budget management. In transition economies, however, ministries of finance are often not sufficiently empowered to perform effectively their policy-making, monitoring and enforcement functions.

Ministries of finance have a lead role in maintaining aggregate fiscal discipline, ensuring compliance with the budget law and enforcing effective control of budgetary expenditures. They must also prepare the draft budget and scrutinise all financial requests going to the council of ministers. These powers, however, are interpreted differently. For example, under a central planning system, the budget prepared by the ministry of finance was basically a mechanical assembling of figures resulting from decisions already made in planning offices, line ministries and public enterprises. In most EU Member States, however, the ministry of finance is given strong authority to act as a “gatekeeper” to the council of ministers on all financial proposals and thus plays a key role in disciplining the whole budget process.

The ministry of finance must be enabled to monitor and control the implementation of the budget. It should have the authority to regulate accounting standards, financial control and internal audit procedures and related personnel and administrative activities. It should have right of access to any information from other ministries and agencies, and other tiers of government (especially important in federal countries like Austria and Germany), which it deems necessary for analysis and control. Box 2.1 describes, for illustrative purposes, the role and responsibilities of the Federal Ministry of Finance in Germany, including in the budget area.
Box 2.1 ORGANISATION OF THE FEDERAL MINISTRY OF FINANCE IN GERMANY

The Federal Ministry of Finance (FMF) can be regarded as one of the “classic” government departments. Within the sphere of budgetary matters, the Minister of Finance is responsible in particular for preparing the draft federal budget and rendering accounts on federal revenue and expenditure, assets and debts. For many years, the tasks of the Ministry of Finance have extended far beyond the mere provision of funds. Taxation and fiscal policy have increasingly been used to help achieve economic and social objectives and to regulate economic activity. In this respect, too, the Ministry’s responsibility for monetary and credit policy both at national and international level is of special significance.

The FMF has a special status in relation to other ministries at the federal level. For example, the Minister of Finance is not bound to accept the expenditure estimates submitted by the supreme federal authorities. The Minister may amend them after consultation with the agencies concerned. The Minister is also entitled to challenge decisions taken by the federal government on matters of financial importance. Only the Federal Chancellor combined with a majority of federal ministers may overrule the vote of the Minister of Finance.

The Federal Ministry of Finance is also responsible for co-ordinating fiscal policies with other levels of government. Thus, the Minister chairs the Financial Planning Council which makes recommendations for the co-ordination of budgets and financial plans of the federal government, Länder and municipalities. This ensures that the budget and the financial plans of public authorities are comparable and employ a standard system of budget classification.

Given the important co-ordinating role of the FMF, a sectoral Directorate within the Ministry deals with the financial relations with the Länder and the municipalities. The activities of this Directorate are concerned with the allocation of tasks and responsibilities between the Federation and Länder, including the division of tax revenues between the federal government, Länder governments and the municipalities.

In 1999, the Ministry consisted of 11 Directorates, 30 subdirectorates and 192 divisions or administrative units with about 2,300 employees. It was responsible for the following main areas:

I Fiscal and Economic Policies.
II Federal Budget.
III Customs Services.
IV Property and Excise Taxes.
V Financial Relations with the Länder and Municipalities.
VI Asset Management.
VII Money and Credit.
VIII Privatisation and Securities Policy.
IX International Monetary and Currency Policy.
X European Policy.

The FMF is also responsible for supervising several public-law bodies and institutions such as the Pension Fund Institution of the Federation and the Länder, the successor organisations to the Treuhandanstalt and the Bank for Reconstruction and Development.

(cont’d)
2. The council of ministers and policy co-ordination

The council of ministers constitutes the key decision-making body at the centre of government.² It approves the main budget parameters and fiscal targets on the recommendation of the finance minister; sets priorities for spending; decides major policy issues; resolves budget disputes between the finance minister and his ministerial colleagues; and approves the draft budget for submission to parliament. It must be noted that much of the council of ministers’ power stems from the fact that it has an exclusive right to present the budget to parliament. This is where parliament’s authority reinforces that of the council of ministers. Since no minister can go to parliament independently to seek funds, all are bound

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Box 2.1 ORGANISATION OF THE FEDERAL MINISTRY OF FINANCE IN GERMANY (cont’d)

Subordinate Federal Authorities of the Federal Ministry of Finance are as follows:

**Federal Authorities**

- Federal Debt Administration.
- Federal Spirits Monopoly Administration.
- Federal Finance Office (incorporating the Federal Pay Office and the computer centre of the revenue administration).
- Customs Authority for Criminal Offences.
- Federal Office for the Settlement of Unresolved Property Issues.
- Federal Banking Supervisory Office.
- Federal Insurance Supervisory Office.

**Regional Authorities**

- Regional Finance Offices.

**Local Authorities**

- Main Custom Offices with their administrative units.
- Customs Office for Investigation.
- Federal Property Offices and Federal Forestry Offices.
to submit their spending plans to the collective judgement of their colleagues. The dynamics of the
council of ministers’ role in budgeting may be usefully seen as balancing the interests of the ministers as
a collective body against the interests of ministers as individuals. The most basic interest of the council
as a collective body is to retain the confidence of parliament and stay in power. How it taxes and spends
are dominant factors in its success or failure. In the nature of things, the individual minister favours ever-increased spending within his sector, a view which conflicts directly with the council’s collective interest in holding down taxes and borrowing while directing spending to the politically most important priorities.

Circulation of information within the government is crucial. Because it is often seen as a commodity
to be traded, information will simply not flow by itself. Formal and robust mechanisms are needed, such
as systematic consultation of other ministries, clear rules for circulation of draft decisions before meetings
of the council of ministers, guidelines for documenting decisions, appropriate rewards or penalties, etc.
But restraint must be exercised to keep communications relevant and avoid the reverse problem of
information overload, which impedes genuine communication almost as much as inadequacy of information.
Committees dealing with cross cutting issues at different administrative levels generally facilitate the
circulation of information, but such mechanisms must not be allowed to dilute the responsibility of line
ministries in their own areas.

Formal rules of procedure and clear communication and clearance channels are important to avoid
misunderstandings, particularly in countries where strong personalised networks are established. The council
of ministers must be the locus where key policy decisions are made; initiatives from ministries should be
submitted to the centre of government; initiatives that affect the public finances to the ministry of finance;
and decisions must be systematically documented and formally communicated.

Close co-ordination and alliance between the minister of finance and the prime minister is important
to ensure overall discipline of the budgeting system. In some countries, an explicit budgeting role for the
prime minister is defined in the organic budget law, but in most cases this key axis and special relationship
takes the form of continuous consultation and development of firm bilateral agreements on major issues.

The centre of government should co-ordinate the policy formulation process. It should be able to
determine policy priorities, prepare council of ministers’ meetings, co-ordinate interministerial committees,
act as an arbiter, and co-ordinate the preparation of strategic plans by sector ministries. The centre of
government needs a strategic planning capability, which might consist of a small group of advisers in regular
contact with the operational ministries concerned. In some countries, a dual policy decision-making
process exists, since government is co-ordinated both by the president’s office and the office of the prime
minister. In these cases, a clear demarcation between the respective roles of these two offices is needed.

Interministerial committees are needed to deal with cross-cutting policy issues (e.g. employment,
environment, etc.); to co-ordinate policy areas that are covered by several ministries; or deal with special
problems (e.g. regional issues). Setting up task forces can be a flexible way to tackle some special issues,
provided that a specific “sunset provision” is enacted to prevent such entities surviving long after the need
for their establishment has disappeared.

A cohesive civil service “culture” is important for effective policy co-ordination. Normally, a flexible
system under which, to the extent practicable, officials are encouraged to move among ministries, and
between professional “streams” such as economics, engineering and general administration, promotes better
policy co-ordination than a system in which civil servants spend most of their careers in the same ministry.
Nevertheless, if this leads to excessive turn over of personnel, efficient co-ordination may be impeded.
Several transition countries face this later problem.
3. Line ministries

Budget management and control is, of course, not the exclusive responsibility of the ministry of finance. Line ministries are responsible for planning, managing and controlling their own budgets. They are accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and their sectoral budgets as well, but within the framework of policies, regulations and procedures laid down by the government. Moreover, line ministries (and not the ministry of finance) have the technical capacities and information needed to make effective trade-offs among ongoing programmes and appraise new policies and programmes.

Line ministries should be responsible for policy-making within their portfolios. This obvious principle bears underlining because it is sometimes violated — either by excessive interventions from the centre on sector policy issues; or from the ministry of finance on sector budget issues; or from the ministry of economy when selecting sectoral projects to be included in a public investment programme; and/or by an evasion of responsibility by the line ministry itself using any of the above as reasons.

The effectiveness of the line minister in co-ordinating sector policy can also be impeded by internal organisational arrangements within the line ministry itself. Thus, for example, in countries where substantial cuts have been made in a ministry’s budget for operational and capital expenditures, an autonomous fund that benefits from earmarked revenues, or a state-owned enterprise in the sector concerned can exercise more power than the relevant minister.

Line ministries are accountable for operational efficiency in public service delivery and must develop actions for improving it. Tight operating budgets are the norm in almost every country. Therefore, line ministries are ultimately responsible for improving public service productivity in their sector, reduce the cost of goods and services purchased by government, and identify the areas in which savings can be made without reducing the quality of service delivery.

There is no blueprint for an optimal organisational structure of government. The common requirement is that the organisational arrangements must ensure coherence and close co-ordination among the different actors. Australia has been successful in implementing super-ministries (“portfolio ministries”), which were made responsible for defining priorities in their sector. This organisational arrangement facilitated adjustments in the composition of expenditure programmes. Putting complementary programmes under a single portfolio highlights the need for policy trade-offs and gives room to finance new priorities through offsetting savings, while complying with overall expenditure ceilings. Nevertheless, in Canada in the 1980s, the Policy and Expenditure Management System (PEMS), which included grouping federal government’s expenditure programmes into nine to ten “policy envelopes” and establishing four policy committees, did not achieve satisfactory results (Sims, 1996). In some countries, a “super-ministry” could be the simple juxtaposition of “junior” ministries. However, this tends to make policy formulation more complex, since an additional layer of decision-making needs to be introduced in the machinery of government.

B. The Role of the Legislature

1. The need for balanced powers

Effective budget management begins with a carefully balanced division of responsibilities between the parliament and the executive branch of the government. Competition for budgetary power is common
but the tension between these two institutions is accepted as one of the vital checks and balances of democracy. With a well-designed constitution and organic budget law, the powers of each are made to reinforce the other. It is an accepted criterion of democracy that the elected parliament holds “the power of the purse”; i.e. it must authorise all expenditures, all borrowings, and all revenues to be collected through the power of the state. In an apparent paradox, however, parliament’s power is reinforced by granting strong authority to the executive government and ministry of finance. Parliament acts by holding the executive accountable. But if the council of ministers does not itself possess the necessary tools or lacks the authority to manage the use of public money, parliament’s control of the executive is left with little meaning. Hence the paradox.

2. Presentation of the budget to the parliament

The enactment of the budget should not be a formal exercise carried out merely to comply with the constitution. The legislature is, generally, the appropriate locus of overall financial accountability. In essence, its role should be to approve future actions rather than rubber-stamp decisions effectively already taken. Thus, the budget should be presented to the legislature in timely manner, that is two to four months before the beginning of the fiscal year, in order to allow budgetary debates to be completed before the beginning of the fiscal year.

The budget is sometimes submitted to the legislature after the commencement of the fiscal year, owing to exceptional circumstances such as a change in the composition of the council of ministers, economic or financial crises, natural disasters or negotiations with international financial institutions (IFI). However, in some countries, delay is institutionalised. In China, for example, the National People’s Congress does not meet to approve the budget until after the commencement of the fiscal year. As a result, it is asked to approve appropriations for a budget that is already being implemented.

Since delays in adopting the budget may occur, the organic budget law should include provisions authorising the executive to commit expenditures before the budget is approved, under specified circumstances. These provisions should be based on the budget of the previous year, rather than on a budget not yet scrutinised.

3. Enactment of the budget

A fundamental issue is the extent of parliament’s power to amend the budget. Members of the legislature have different preferences regarding the manner in which resources are allocated and are subject to a variety of pressures from constituents. The sum of these various preferences and related claims can generate a systematic tendency to increase expenditure during budget debates (a phenomenon known as “log-rolling”). Accordingly, many countries have adopted procedural rules to regulate and limit legislature debates on the budget. These rules cover (i) the sequence of voting on the budget; and (ii) the legislature’s powers to amend the budget.

In order to enforce ex ante fiscal discipline, in several countries the budget is enacted by parliament in two phases. The overall expenditure ceiling is approved first, and appropriations and the allocation of resources among ministries are approved only in the second phase. This procedure is aimed at protecting the aggregate expenditure limit and the overall fiscal targets. Some commentators argue that the real impact of this procedure is unclear since legislators can anticipate the broad impact of the budget on their favoured programmes before the first stage and decide the overall expenditure ceiling accordingly. However, reviewing aggregate expenditures and revenues together has the advantage of allowing the legislature to discuss macroeconomic and fiscal policies explicitly and should be considered favourably by transition countries.
Sweden has even gone further and uses a two-stage, top-down, budgetary approval process (see Box 2.2). The fiscal targets adopted by parliament in April create the limits within which the budget is prepared.

**Box 2.2. THE BUDGET APPROVAL PROCESS IN SWEDEN**

A key reform implemented in Sweden in 1994 has been the introduction of a top-down approach for discussing and approving the government’s budget proposal. In April each year, prior to the presentation of the budget, parliament approves the level of *aggregate government expenditures* (and aggregate government revenues) in a Fiscal Policy Bill. The government’s budget proposal must conform to this limit unless the government separately proposes a higher limit. Parliament’s deliberation of the actual budget proposal is then divided into two distinct phases. Parliament approves the level of *expenditures for each of 27 expenditure areas*. Only then does Parliament approve the level of *individual appropriations* within each of these areas.

The timetable for parliamentary scrutiny of the government’s budget proposals is as follows:

15 April  The Government presents the Fiscal Policy Bill to Parliament.
Early June  Parliament approves the Fiscal Policy Bill.
20 September  The Government presents the Budget Bill to Parliament. Expenditures are divided into 27 Expenditure Areas which are in turn divided into 500 individual appropriations.
End November  Parliament approves in one vote the total expenditure for each of the 27 Expenditure Areas.
End December  Parliament approves individual appropriations within each of the 27 Areas with one vote for each Expenditure Area.
1 Jan  Start of the fiscal year.

*Source: OECD (1998a).*

In most transition countries, priority should be given to strengthening the budget preparation process as discussed in Chapter 5. However, consideration could be given to a two-stage approach to budgetary approval, or at least to informing the parliament of decisions taken by the government in the first stage.

The powers of the legislature to amend the draft budget vary from country to country. These differences can be classified as follows:  

- *Unrestricted power* is the ability of the legislature to vary both expenditure and revenue in either direction, without consent of the executive. Some presidential systems have adopted this model. The US Congress, for example, has very extensive powers of amendment. Frequently, it discards entirely the draft budget submitted by the President and, taking advantage of its extensive research resources,
compiles a quite different budget. However, these extensive powers granted to the legislature are partly counter-balanced by a presidential veto.

- **Restricted power** is the power to amend the budget within set limits, often defined as a maximum increase in expenditures or a maximum decrease in revenues. The extent of these restricted powers varies from country to country. In several countries within the Westminster tradition, the parliament is forced to approve the budget without amendment, otherwise forcing the government to resign. In France, the Parliament is not allowed to propose amendments that increase expenditure. By contrast, Germany allows such amendments, but only with the consent of the executive.

- **Balanced budget power** is to the ability to raise or lower expenditure or revenue as long as there is a counter-balancing measure to maintain the budget balance.

Limits on the power of legislature to amend the budget are particularly needed where debates in parliament lead systematically to increased expenditures, as has recently been the case in a number of transition countries. More generally, a parliament that makes many amendments to the budget undercuts its own ability to criticise the council of ministers later if these changes result in a weakening of fiscal discipline. Central and eastern European parliaments, therefore, are well advised to design their legal framework to ensure a sound balance between the legislative and executive powers. They should also develop strong and effective expenditure review procedures and other measures for holding the government to public account. The supreme audit institution can provide valuable support to the parliament in this role (see Chapter 14).

The legal framework should also stipulate that legislative actions that increase expenditures can go into effect only if these expenditures themselves are authorised in the budget or supplementary legislation. Two other legislative practices are being considered in some OECD Member countries — namely, permanent or standing appropriations, and very detailed programme laws. The second procedure, reflecting an attempt by certain parliaments to extend their reach into day-to-day administration of programmes, has been found to create the very rigidities and inefficiencies that all governments are trying to eliminate (O’Toole, 1997).

4. **The role of parliamentary committees**

Strong and capable parliamentary committees enable the legislature to develop its expertise and play a greater role in budget decision-making. Generally, different committees deal with different facets of public expenditure management. For example, the budget and finance committee reviews revenue and expenditures and in many countries plays an important co-ordinating role in processing the annual budget law; a public accounts committee ensures legislative oversight and provides a link with the supreme audit institution; sectoral or standing committees deal with sectoral policy and may review sector budgets. Co-ordination between the activities of these committees should be effective. In countries where the role of the legislature in amending the budget is significant, amendments are generally prepared by sectoral committees, and co-ordinated by the budget and finance committee, rather than being proposed on the floor by individual members.

The time allocated for the legislative budget process and, within this process, to committee reviews, must be sufficient to ensure a sound scrutiny of the budget. In the German *Bundestag*, for example, legislative budget deliberations may last up to four months.

The legislature and its committees should have access to independent expertise for proper budget scrutiny. Committees should also have access to any information from the ministry of finance and line ministries
that is relevant to its scrutiny procedure. In Germany, the budget committee interacts quasi-permanently with government departments through regular departmental briefings and expenditure reports. Frequent consultations between the administration and the legislative committees on budget policies and their implementation, outside the pressured environment of the discussions and debates surrounding the annual budget, are desirable. They provide the executive with an effective mechanism for consulting widely on the appropriateness of policies, and strengthen the capacity of the legislative to scrutinise the budget and the government’s fiscal policies.

5. Approval of final accounts

In every democratic country, the circle of parliament’s budgetary authority is closed with the approval of the final account and the report of the supreme audit institution (SAI) which in many cases issues a formal certification of that account. Important characteristics of the SAI are that it is responsible only to parliament, is independent of government or other political factions and possesses high professional skills. The role of external audit and the SAI is discussed in Chapter 14.

C. Distribution of Responsibilities between Different Levels of Government

This book is focused on central government expenditure. Nevertheless, certain key issues related to the fiscal relationship between national and subnational levels of government must be considered. As mentioned in Chapter 1, each governmental entity (central government, state, municipality, etc.) should have its own budget, enacted according to the provisions stipulated in the constitution or by law. However, there are strong linkages between the budget of the central government and the budgets of subnational governments. Moreover, the expenditure, tax and borrowing policies of subnational governments have important implications for the overall fiscal and economic performance of a country. The design and implementation of these policies are therefore matters of direct concern to the national government, and to the ministry of finance in particular.

1. “Fiscal federalism”: key issues

The degree of authority and the range of responsibilities assigned to subnational governments, the assignment of expenditures and the borrowing powers of subnational governments, and the revenue raising or revenue sharing arrangements, should be tailored to the country context and depend on many policy and political issues.

From an efficiency perspective, the Oates’ “decentralisation theorem” (see Shah, 1994) states that: “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise benefits and costs of such provision.” According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government. Similarly, the European Union has adopted the general principle of “subsidiarity” to define the areas where Member States have independent rights of action, i.e. where the acquis communautaire does not apply.

Decentralisation is a very complex matter, both in general and in relation to the management of public expenditure. It is generally desirable from the viewpoint of efficiency and local accountability. These criteria must be balanced with other elements, such as spatial externalities; economies of scale; overall fiscal efficiency (e.g. more generous public services in one region will encourage people to move there, even if employment opportunities do not exist); regional equity; and the redistributive responsibilities of
the government. The administrative capacity of subnational governments, and the administrative and compliance costs of decentralisation must be taken into account when assigning expenditures among levels of government. Political issues and, in a number of countries, ethnic or nationality problems cannot be ignored either.

The literature on fiscal federalism discusses these issues and gives hypothetical and real-life examples of expenditure assignment. It also presents various and, to some extent, contradictory point of views on the desirable degree of decentralisation. The need for some increase in fiscal decentralisation is generally admitted. Many observers, however, stress the risks of loss in expenditure control, increased corruption and inefficiencies in resource allocation that may result from hasty or over-extended decentralisation, even when such decentralisation is justified on other grounds (see Prudhomme, 1994).

Tax and revenue arrangements should be in conformity with expenditure assignment, and take into account efficiency issues in tax administration. Such arrangements may include: (i) assigning certain taxes to subnational governments; (ii) tax sharing agreements; (iii) providing a share or pool of tax revenue to subnational levels of government; (iv) unconditional grants or transfers from the central government; (v) conditional grants or transfers that are subject to certain conditions or standards in delivering services; and (vi) targeted grants for specific purposes or projects.

2. Broad principles

Whatever the degree of devolution appropriate to the country, the framework that governs the relationships between the central and local governments and arrangements for budgeting should be clear and efficient. A legal framework should govern the relationship between the different levels of the government. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to ensure smooth intergovernmental fiscal relations. Such mechanisms can operate through specialised bodies. In Germany, the second chamber of the Parliament and representatives from the Länder contribute to intergovernmental policy co-ordination. Specialised sectoral co-ordination councils are common in many countries.

For transparency and efficiency of management:

• Each level of government should have clearly assigned responsibilities, regardless of what responsibilities are assigned to government as a whole. Overlaps should generally be avoided, and long “concurrent lists” of shared responsibilities are particularly ambiguous.

• Fiscal and revenue-sharing arrangements between the central and local governments should be stable and predictable. They may be amended from time to time, but renewed bargaining each year should be avoided.

• Subnational governments need to have a reliable estimate of the revenues available to them before preparing their budgets. In some transition countries, subnational governments have to wait for the draft budget of the central government to be finalised before preparing their own budgets. Such lack of predictability impedes both efficiency and financial control at local level. Without an indication of the level of resources to be transferred to them, subnational governments cannot adjust their expenditures to meet perceived fiscal constraints. Accordingly, forecasts of revenues should be transmitted to subnational governments as soon as they are decided, and estimates of grants to local government need to be prepared early in the budget process.
• Incentives for increased efficiency in delivering services at subnational level are needed. Often the central government adjusts downwards its transfers to subnational governments when they make economies in public spending or improve their own tax collection. This can create perverse incentives at the local level. Consideration should be given to allowing subnational governments to take a share in any savings they make through improved efficiency.

• It could be desirable to agree on multi-year “contracts” between the central government and subnational governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include minimum standards for services rendered by subnational government. They should define relationships in a transparent manner and establish procedures for monitoring and control.

• National law should provide standard accounting and budgeting rules for subnational governments.

For expenditure control and the strategic allocation of resources:

• Fiscal targets should cover the general government sector (see Chapter 5).

• Revenue assignment should be fully consistent with expenditure assignment. Sufficient resources should be assigned to subnational governments in order to allow them to fulfil their duties. When new duties or responsibilities are transferred to subnational governments, supplementary funding should be provided. On the other hand, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.

• “Downloading” the fiscal deficit should not be permitted (defining fiscal targets for general government should help avoid this problem). When balancing its budget, the central government should avoid passing its financial problems to subnational governments through cuts in intergovernmental transfers or increased expenditure assignments, without compensatory measures. To do so would either not change the aggregate borrowing requirements of the general government, or generate arrears.

• Special mechanisms are needed to control subnational government borrowing (see Subsection 3 below).

• In the case of subnational government budget overruns or the accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, subnational authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited period of time until the situation is stabilised.

• A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal (management) control and internal audit for subnational governments should be similar to those of the central government. Ideally, they should be subject to regulation by the ministry of finance.

• For the purposes of policy analysis (as well as setting fiscal targets at the general government level), it is necessary to consolidate the expenditure of the different levels of government. In many countries, it would be very difficult to know what is spent on key sectors, such as education and health, based only on the accounts of the central government. For this purpose, subnational governments and central government should have a common functional and economic classification of expenditures, based on international standards (see Chapter 4).
3. **Control of borrowing of subnational governments**

As discussed in Chapter 5, fiscal targets, such as the overall surplus or deficit and the net borrowing requirement should be set for the general government. The central government can control its deficit when preparing the budget, then directly through the procedures that are established for controlling the execution of the budget. Since subnational governments have their own budgets, the central government needs generally special instruments to control any deficits that subnational governments incur. Depending on the degree of decentralisation, these instruments consist of grant mechanisms, fiscal targets set up by law and direct controls on borrowing. Control of borrowing is the more effective instrument to ensure that net borrowing, and therefore, the cash deficit will be in line with the fiscal targets.

Many EU countries have adopted a “golden rule”, which limits subnational governments’ borrowing for investment purposes (e.g. Germany). Moreover, several EU countries in addition to the “golden rule” have set up additional controls on borrowing (e.g. the UK). Some countries allow short-term borrowing for liquidity purposes, but generally stipulate that such borrowing has to be repaid by the end of each fiscal year.

In transition economies, the stage of development of financial markets and weaknesses in the system of public information do not allow the central government to rely only on market discipline to control the borrowing policy of local governments. A golden rule for subnational government budgets is generally desirable, but additional controls and/or rules may be also needed to ensure compliance with the fiscal targets.

Direct controls over borrowing may take different forms such as annual borrowing ceilings; ex ante authorisation of individual borrowing operations; or centralisation of all local government borrowing through the ministry of finance and/or central bank. Two elements need to be considered when designing procedures for controlling subnational government borrowing. First, the objective of increasing devolution and diminishing bureaucratic procedures suggests developing a system, at least for domestic borrowing, that is based on rules which apply at the level of the subnational organisation rather than on ex ante control of individual operations through a central government agency. Second, rules should be appropriately designed to avoid the creation of mechanisms to bypass them, such as, for example, misclassification of expenditures or the setting up of ad hoc funds for borrowing. They could, for example, be based on the ratio of the current and projected levels of debt to revenues. Some countries lay down detailed eligibility criteria that determine which local governments are allowed to borrow. These criteria are based on the soundness of the subnational government policy and administrative procedures, and the nature of projects that can be financed from borrowing.

In relation to external borrowing, central co-ordination of the external debt policy is required. Its impact on the balance of payments must be taken into account. Approaches to foreign capital markets and negotiations with international financial institutions need to be co-ordinated. Moreover, foreign lenders, when lending to subnational governments, generally require an explicit or implicit guarantee from the central government. Therefore, at a minimum, lending operations made abroad by subnational governments should comply with conditions set by the central authorities.

### D. The Legal Framework

1. **Components of the legal framework**

The legal framework for public budgeting consists of several levels, namely: the constitution, the organic budget law (or budget management law) and related laws (e.g. accounting, public debt management, treasury...
management, financial control, external audit, and local government finance), the annual budget law and supplementary budgets, and financial regulations and instructions.

The constitution deals in general with the broadest principles of public finance covering for example: (i) the requirement that all public funds be paid into designated accounts, and that these funds can be spent only under the authority of the legislative; (ii) the financial relations between the national and subnational levels of the government; and (iii) the distribution of powers in budgeting between the executive and the legislature. When they are not stated in the constitution, these key principles should be dealt with in the organic budget law.

An organic budget law (OBL) provides the indispensable legal base for all key roles and relationships described earlier in this chapter, and binding principles for budget management and auditing. In some countries (e.g. the US), fiscal management is framed by several acts covering specific areas, instead of one single organic law. The United Kingdom and some other common law countries, have a number of financial regulations and accounting guidelines, but do not have an organic law. They rely heavily on established administrative practice and the procedures of parliament as a basis for budgeting rules. By contrast, civil law countries such as France, Germany and Italy have extensively codified their legal framework, and their organic budget laws. Transition countries cannot rely on their previous administrative and legislative practices and need to establish binding principles in fiscal management. They should, therefore, adopt the latter approach and frame their fiscal management by an OBL that meets the standard of best practice.

Transition countries may find it useful to use the OBL to deal with specific weaknesses of budgetary management and control. For example, in relation to the central government, it should deal with the following issues: (i) the array of special powers and prerogatives conferred on the ministry of finance, which are often insufficiently specified; (ii) the respective roles of the executive and the legislature; and (iii) regulations concerning the implementation of the annual budget laws.

In relation to subnational governments, it is preferable to introduce in separate legislation local government finance issues relating to the allocation of powers over taxes and expenditure assignment. Provisions in the OBL can focus on control of borrowing and reporting requirements. In some FSU countries, the OBL includes detailed provisions on the preparation of the budgets of oblasts (regions) and rayons (counties) and their consolidation into the national budget. In practice, however, these levels of government are deconcentrated entities rather than local self-governments.

Depending on legal traditions, some countries include less detail in the OBL and more in secondary legislation and administrative policies. Others do the opposite. It is generally preferable to limit the OBL to key provisions of lasting importance, and define other rules in lower-level legislation and instructions, which can be amended more easily when circumstances change. The main provisions to be included in the budget legislation are reviewed below, but the respective coverage of the OBL and lower-level legislation, and the level of detail included in the OBL must be defined in the light of specific national practices.

2. Main provisions of budget legislation

Figure 2.1 summarises the main elements of an OBL. Features of an OBL can be divided into three broad areas: general principles, issues related to budget formulation, and issues related to budget execution and audit. To ensure a common understanding of budgetary principles, the OBL should include a section that defines the terms and concepts used.
**a. Fundamental principles**

The principles of integrality and universality of the budget should be clearly stipulated in the OBL. The principle of integrality requires that revenues and expenditure be presented in a single document, while the principle of universality requires that all revenues and expenditures be presented in that document. Both principles are fundamental to the strategic allocation of resources and fiscal discipline.

The OBL should also:

- Authorise the government accounts into which all public money must be paid and from which expenditures are made only by appropriation of the parliament. All government receipts should go either to a single account, or to accounts placed under a single authority (the ministry of finance/treasury). The management of some accounts/sub-accounts can be delegated by this authority to line ministries but under strict conditions to be specified in the financial regulations. Consolidated financial statements must be regularly produced.
• Limit the creation of special or extra-budgetary funds to exceptional cases, authorised by separate statute, and stipulate that the expenditures and revenues of these funds are included in the budget and presented according to a standard classification, together with the relevant financial statements.

b. **Budget classification and definition of the budget deficit/surplus**

The OBL should specify that the classification of revenues, expenditures and financing transactions, and the form of accounting, is prescribed by regulations under the authority of the minister of finance (see also paragraph k). To consolidate its role in macroeconomic management, the budget should give a clear picture of the fiscal situation, based on clear analytical definitions. For this purpose the OBL should also include the following:

• Definitions of the main elements of receipts and expenditures that are to be included in the estimates (for example, tax revenue must be separated from non-tax revenue and repayment of debt principal from interest payments).

• Definitions of the deficit/surplus. In countries with ambitions to join the European Union, the deficit should be preferably defined according to the EU standards (ESA95). But the fact that loans granted by the government are "below the line" when calculating the deficit does not mean that they should not be appropriated.

• Provisions which stipulate that the deficit limit should be explicitly included in the annual budget law (or appropriation law).

c. **Powers of the ministry of finance over budget management**

As discussed earlier, the ministry of finance must be sufficiently empowered to and have sufficient skilled staff to accomplish its functions. The financial legislation should therefore stipulate that the minister of finance is responsible for the following:

• Supervising the preparation of the annual budget, all government bank accounts, receipt and disbursement of funds, and all central government assets and liabilities, and be the signatory for all borrowing and lending by government.

• Ensuring that expenditures and the use of credit are controlled within limits specified in the annual budget law.

• Scrutinising all expenditure or financing proposal and make recommendations on these matters prior to approval by the legislature.

• (With approval of the council of ministers) sequestering appropriations if the amount of collected revenues is insufficient to cover the expenditures.

• Requesting reports on all public accounts (even when they are set up outside the budget framework).

d. **Appropriations**

The OBL and other financial regulations must specify the way in which the use of public money is to be authorised. They should include provisions in the following areas:
• The degree of freedom of the executive in reallocating funds between budget items, or rules for transfers between appropriations. As mentioned earlier, the border between the spheres of responsibility of the executive and the legislature is defined through an appropriation act separate from the budget, or through the rules defining the degree of freedom of the executive in re-allocating funds among “chapters”, or both. The OBL can give a certain degree of flexibility to the executive in making transfers between appropriations or chapters, but this flexibility should be properly defined in order to prevent altering, during the budget execution phase, policy objectives that are clearly stated in the budget. The level of flexibility should depend, in a large part, on the degree of aggregation of the appropriations.

• Appropriations are spending limits for the purposes specified in the annual budget law. However, special provisions may be established for some compulsory expenditures, such as debt servicing, or for proprietary funds related to the sales of goods and services.

• Time limit for the authority to spend should generally lapse at the end of the fiscal year. In countries with good fiscal discipline, carrying over capital expenditures and, eventually, a small share of current expenditures can be considered. This promotes efficient resource allocation. In such cases, however, the financial regulations must specify rules to authorise carry over, which should be submitted to prior approval of the ministry of finance (see Chapter 7).

• Contingency reserves included in the budget may cover urgent expenditures, unforeseen expenditures or increases in entitlements. They should be used under restrictive conditions and their uses fully reported to parliament. Their amount should be limited to a small percentage of the total spending. They should be spent (or funds transferred to another appropriation) on the authority of the ministry of finance.

• Special provisions for budgeting and scrutinising secret activities of the state.

• Special provisions for continuing the normal activities of the government if the annual budget law has not been approved by parliament prior to the start of the fiscal year (for example, one twelfth of the previous year’s appropriation per month).

• Provisions for managing forward commitments through “authorisations for forward commitment”, if such authorisations are included in the budget.

e. Revenues

The government’s legal rights to collect revenues (taxes, fines, various levies, etc.) should be authorised by law. In a number of countries these rights are granted by the annual budget law. The OBL should contain a provision to ensure that such obligations to the government shall not be waived without the express or delegated authority of the minister of finance. The ministry of finance should report on tax expenditures to parliament and such expenditures should be audited.

f. Presentation of the budget to parliament and the approval procedure

The OBL and other financial regulations should specify the following:

• The time by which the executive must present the budget estimates to parliament.

• The time by which the parliament must approve the budget.
• Basic requirements concerning the form and content of the budget.

• Requirements to specify the fiscal targets (e.g. the deficit and debt ratios) for the budget year.

• Requirements to present the medium-term macroeconomic strategy of the government and its economic policy objectives with the budget. Such documents show the policy commitments of the government, but do not have the binding status of a law. Because of the difficulty of proposing a realistic and sustainable target, setting medium-term budget deficit limits by law will be difficult in most countries (see Allan, 1994).

• Provisions to regulate parliamentary debates and the powers of parliament to amend the budget.

• Provisions stipulating that legislative or executive decisions which increase expenditures should go into effect only if these expenditures themselves are authorised in the budget or its supplementary acts.

• Provisions concerning the presentation of supplementary budgets. As discussed in Chapter 6, the number of budget revisions during the fiscal year should be very limited. If under special circumstances, the government is obliged to make a budget revision, the revised budget should be submitted to parliament for approval within a specific time period.

g. Preparation of the budget

As noted earlier, the ministry of finance should be empowered to co-ordinate the budget preparation process. The formulation of budget requests by spending agencies should be based on statements of government policy priorities and fiscal policy objectives and on detailed assumptions and guidance issued by the ministry of finance each spring as a “budget circular”. The OBL should require line ministries to comply with directives and guidelines given by the ministry of finance in the budget circular. The ministry of finance should be empowered to establish guidelines for evaluating investment programmes within overall budget priorities. Transfers from the government’s budget to public enterprises should be subject to specific guidelines. The financial legislation should also give the deadlines for presenting the budget to parliament (see paragraph f above).

h. Execution of the budget

In relation to budget execution, the OBL should include the following provisions (some of which will empower the minister - or ministry - of finance to issue detailed regulations on issues relating the financial management of public funds):

• A provision that no expenditure can be undertaken by any ministry except under authority issued by the minister of finance (for example, apportionment of appropriations, budget implementation plans, warrants, etc.).

• Requirements for implementing the budget and setting in-year cash limits.

• Provisions empowering the ministry of finance to issue regulations concerning transfers between budget items, within the same appropriation or chapter, and the respective powers of line ministries and the ministry of finance in authorising them.
• Provisions for the minister of finance, through the council of ministers, to report back to parliament any major changes that have been implemented in the budget or if it is clear that the deficit specified is likely to exceeded under existing policies and economic conditions.

• Provisions that monitoring reports on the expenditures, revenues and debt of state and local budgets should be issued monthly, and prepared according to the guidelines established by the ministry of finance.

• Provisions that the minister of finance should submit a mid-year report to parliament on the progress of budget execution.

• Sequestering procedures (see paragraph c above).

• Provisions to define the responsibilities of the treasury for financial execution of the budget.

• Provisions to define responsibilities for internal control, notably to ensure compliance with budget authorisations and procurement legislation and to prevent misuses of funds and mismanagement of assets.

• Provisions for internal audit.

i. Government borrowing and issuance of guarantees

Concerning government borrowing and issuance of guarantees, the OBL should include the following provisions:

• Only the minister of finance is authorised to borrow and grant guarantees. Other ministers are not authorised to negotiate loans without a mandate from the minister of finance.

• Loans can be contracted for amounts only up to the financial limits specified by the annual budget law.

• The government, through the minister of finance, can issue guarantees for debt incurred by private or public entities under certain conditions, for example: (i) guarantees or an annual ceiling for guarantees must be approved by parliament; (ii) all guarantees are presented to parliament and published in the official gazette; (iii) possible liabilities falling due in the financial year are shown as a supplement to the annual estimates and a contingent provision is included in the estimates to cover possible losses; and (iv) the ministry of finance maintains a register of all contingent liabilities of government.

• The government has no liability for the debt of its autonomous entities, except any loans it has guaranteed or amounts it is required to contribute by law.

• Strict rules to control subnational government borrowing.

j. Banking and financial assets

The minister of finance should be responsible for opening, closing and either directly operating or monitoring the operating of all bank accounts of the central government.

k. Financial reporting and audit of accounts

The minister of finance should prepare appropriate reports and submit financial documents to an external auditor, usually the supreme audit institution. The following provisions should be included in the OBL:
The ministry of finance is required to prepare a consolidated statement giving the financial position of general government and statements for each of the central government funds for that financial year. The statements to be prepared should include, at a minimum: (i) the financial position at the beginning and end of the year; (ii) revenue and expenditures (compared to appropriations); (iii) borrowings for the year and total borrowings to date; (iv) contingent liabilities as at the end of the year; (v) emergency procedures incurred during the year; and (vi) comparative outturn figures for the previous financial year.

The supreme audit institution is independent of the executive and is responsible for auditing all public moneys, assets, accounts and other financial records.

The treasury is required to forward the annual financial statement to the supreme audit institution (by no later than, say, two months after the end of the financial year).

The supreme audit institution is required to issue an audit opinion on the government financial statements by a specified time.

The minister of finance must submit the annual financial statements together with the audit report to parliament.

The form of accounting is prescribed by regulations under the authority of the minister of finance. The supreme audit institution, in consultation with the ministry of finance, should establish accepted accounting practices for preparation of government financial statements.

The ministry of finance establishes the requirements for annual financial statements and management reporting by ministries and budget-dependent agencies of government.

1. Accountability and sanctions

A general section on accountability and sanctions, requiring compliance with the provisions of the OBL and the annual budget law should be included in the OBL. This section should define clearly the respective responsibilities of line ministries and the ministry of finance in ensuring compliance.

The regulations should impose a duty on public officials to report suspected criminal behaviour, and establish a graduated set of administrative sanctions for infractions of budget legislation. To be practicable the system of sanctions must fit the degree of mismanagement. In some transition countries, the system of sanctions covers only “criminal activities”, and is therefore difficult to apply in cases of less serious misdemeanours.

m. Subnational levels of government

Detailed provisions concerning the budget process and financial management procedures at the various levels of subnational government, and the often complex fiscal relationships between the central and subnational levels, need to be defined in separate legislation. However, the OBL should include provisions on:

- The basic principles of financial management, control and external audit, and of revenue sharing arrangements, if any.

- Restrictions on borrowing.
• Budget accounting methodologies and classifications so that these are coherent and common to all levels of government.

n. Definition of government entities

The budget legislation should define the difference between those bodies that carry out the functions of the central government (agencies of the central government), and those that function in their own right (entities of the public sector). It should define the different classes of budgetary institutions, agencies and enterprises, the authority for creating and dissolving such bodies, and the rules for financial management and control of the entities in each class.

o. EU budget issues

In candidate countries, it is necessary to provide a legal basis for the management and control of financial flows to and from the EU budget, for the functioning of the National Fund and the distribution of responsibilities under the Memorandum of Understanding between the countries concerned and the European Commission. The legal framework should stipulate that all expenditures from the National Fund are included within the budget, according to a standard classification and are submitted to similar scrutiny and control as other expenditures. In all EU Member States, EU budget flows are fully integrated with the national budget in this way.
INDEX

1. Drawn up in a large part from O’Toole (1997). The expression “ministry of finance” as used in this chapter can also refer to the power and authority of the ministry of finance, within the executive branch of the government and in relation to the parliament. Such powers are vested both in formal rules and procedures and in informal behavioural norms and cultural traditions, which can vary widely from country to country. Some traditions and legal systems confer all authority to the finance minister personally; in other countries, the ministry itself exercises certain powers and authority in its own name.

2. Depending on the country, the “centre of government” comprises the office of the president and the office of the council of ministers or prime minister’s office.

3. Throughout this book the term “council of ministers” is used to mean the group of senior ministers, chaired by the prime minister, that meets regularly in order to discuss government policy. Equivalent terms include “cabinet”, “cabinet of ministers” and “government”.

4. In France, for example, this function is exercised systematically by the General Secretariat of the Government; in the United Kingdom, by the Cabinet Office.


9. See, for example, Shah (1994) and Ter-Minassian (1997).


11. In China, local governments are not permitted by law to run deficits or to borrow from the local branches of the Peoples Bank of China. However, local governments undertake indirect borrowing mainly by creating financial companies that borrow to finance local government expenditures. See Ahmad in Ter-Minassian (1997).

12. For example, Korea; see Chu and Norregaard in Ter-Minassian (1997).

13. In some countries (e.g. France) an organic law has a special constitutional status, in others its status is equivalent to that of other laws.
