



USAID
FROM THE AMERICAN PEOPLE

GUIDE TO PUBLIC FINANCIAL MANAGEMENT

BUREAU OF ECONOMIC GROWTH, EDUCATION AND
ENVIRONMENT

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AUTHORS:

Deloitte Consulting LLP

Hilary Mclellan, Editor – Overall content and editing, Introduction, Sequencing PFM Reforms, Conclusion
Ron McMorran – Thought leadership
Anton Kamenov – Budget Planning and Preparation
Lincoln Wheeler – PFM Stakeholders, Conclusion, and Case Studies
Nate Malone – Public Sector Accounting, Audit and Evaluation
Ronnie Saha – Budget Execution

USAID

Editors: Eric Hyman, PhD
Frances Provencher-Kambour
Lawrence K. Daum – also Sequencing PFM Reforms, additional content throughout

TABLE OF CONTENTS

ACRONYMS	V
I. INTRODUCTION	1
I.1 The Purpose of the Public Financial Management (PFM) Primer.....	1
I.2 Structure of the PFM Primer	2
I.3 Additional Resources	2
I.4 What Is Public Financial Management?	2
I.4.1 Fiscal Discipline.....	3
I.4.2 Efficiency in the Allocation of Resources	3
I.4.3 Efficiency in the Delivery of Public Services.....	3
I.4.4 Characteristics of a Sound PFM System.....	4
I.5 Public Financial Management at the Sub-National Level	4
II. BUDGET PLANNING AND PREPARATION	7
II.1 Overview.....	7
II.1.1 Legislative Framework.....	9
II.2 Budget Planning Process	11
II.2.1 National Development Plan	12
II.2.2 Macroeconomic Framework.....	12
II.2.3 Fiscal Framework	13
II.2.4 Macro-Fiscal Framework.....	14
II.2.5 Medium-Term Expenditure Framework.....	15
II.3 Budget Preparation Process	17
II.3.1 Budget Circular	17
II.3.2 Budget Calendar.....	19
II.3.3 Budget Requests and Negotiation.....	20
II.3.4 Types of Budget Approaches	21
II.3.5 Capital Budget	24
II.3.6 Public Investment Programs	25
II.3.7 Budget Approval	25
II.3.8 Supplementary Budget.....	27
II.3.9 Transparency.....	28
II.3.10 Responsible Parties.....	29
II.4 Common Challenges	30
II.4.1 Lack of Capacity	30
II.4.2 Abbreviated Preparation Timeline	30
II.4.3 Budget Coverage and Off-Budget Operations	30
II.5 Implementing Reform	32
III. BUDGET EXECUTION	34
III.1 Budget Authorization and Apportionment	35
III.2 Acquisition & Verification.....	36
III.2.1 Procurement Systems	36
III.2.2 Requisition Request	37
III.2.3 Bid Solicitation	37
III.2.3 Bid Evaluation.....	39
III.2.4 Contract Negotiation and Signature	40
III.2.5 Contract Management	40
III.2.6 Verification.....	41

III.2.7 Project Close-Out	41
III.2.8 Common Challenges	42
III.3 Payment Procedures	43
III.4 Asset Management and Inventory	44
III.5 Payroll.....	44
III.6 Commitment of Funds	45
III.7 Revenues	47
III.7.1 Revenue Policy Considerations During the Budget Process	48
III.7.2 Taxes	49
III.7.4 Tax Administration.....	52
III.8 Treasury Operations and Cash Management	54
III.8.1 Treasury Single Account	56
III.8.2 Debt Management	59
III.9 Common Challenges.....	62
III.10 Implementing Reform	63
IV. PUBLIC SECTOR ACCOUNTING.....	66
IV.1 Basis of Accounting	66
IV.1.1 Cash Basis Accounting	66
IV.1.2 Accrual Basis Accounting	67
IV.1.3 Modified Accrual/Cash Basis Accounting	67
IV.1.4 Transitioning the Basis of Accounting.....	68
IV.2 Chart of Accounts	69
IV.3 Financial Management Information Systems	71
IV.4 Common Challenges	74
IV.4.1 Weak Regulatory Environment	74
IV.4.2 Limited Technology	75
IV.4.3 Lack of Professional Organizations for Accountants	75
IV.4.4 Human Resources	75
IV.4.5 Financial Resources.....	76
IV.4.6 Tax System	76
IV.5 Implementing Reforms.....	76
V. AUDIT AND EVALUATION.....	78
V.1 Internal Audit.....	79
V.1.1 Institutional Organization.....	80
V.1.2 Challenges	81
V.2 External Audits	81
V.2.1 Institutional Organization.....	82
V.2.2 Challenges	82
VI. STAKEHOLDERS FOR EFFECTIVE PFM.....	84
VI.1 Executive Branch	84
VI.2 Legislative Branch.....	85
VI.3 Other Stakeholders	86
VII. SEQUENCING PFM REFORMS.....	88
VII.1 PFM Assessments	89

VII. 2 Sequencing Approaches.....	90
VII.2.1 Basics First.....	90
VII.2.2 Platform Approach	91
VII.2.3 Evolutionary Approach	93
VII.2.4 The USAID Integrated Phase Approach.....	93
VII.3 Good Practices in Sequencing Reforms.....	102
VIII. CONCLUSIONS	106
Annex 1: Case Study of Kosovo Fiscal Reform	107
A 1.1 Context.....	107
A 1.2 Overview of the Reform	107
A 1.3 Results and Lessons Learned	110
Annex 2: Case Study of Establishing PFM Systems for a New Country: The South Sudan Example.....	113
A 2.1 Context.....	113
A 2.2 Overview of the Reforms.....	113
A 2.3 results and lessons learned	116
Annex 3: COFOG and GFS Category Groups and Functions	102
Annex 4: Developing PFM Indicators.....	109
4.1 Introduction.....	109
4.2 USAID PFM Monitoring and Reporting	109
4.3 Selecting Indicators for PFM Programming.....	116
4.4 Collecting and Setting Baselines and Targets for PFM Indicators	116
4.5 Data Sources and Data Verification for M&E of PFM Programming.....	116
4.6 Systemic PFM Indicators.....	114
GLOSSARY	138
REFERENCES.....	145

ACRONYMS

AICPA	American Institute of Certified Public Accountants	IFRS	International Financial Reporting Standards
CBO	Congressional/Central Budget Office	INTOSAI	International Organization of Supreme Audit Institutions
COA	Chart of Accounts	IPSAS	International Public Sector Accounting Standards
COFOG	Classification of the Functions of Governments (United Nations)	ISSAI	International Standards on Supreme Audit Institutions
CPA	Comprehensive Peace Agreement	IT	Information Technology
CSO	Civil Society Organization	LDA	Local Development Authority (in Tanzania)
DDLG	Decentralization and Democratic Local Government	LIB	Limited International Bidding
EU	European Union	MDA	Ministries, Departments and Agencies
FAR	Fixed Asset Register	MOF	Ministry of Finance
FMIS	Financial Management Information System	MOFEP	Ministry of Finance and Economic Planning
GASB	Government Accounting Standards Board	MTBF	Medium-Term Budgetary Framework
GAAP	Generally Accepted Accounting Principles	MTEF	Medium-Term Expenditure Framework
GCIA	Government Chief Internal Auditor	NCB	National Competitive Bidding
GDP	Gross Domestic Product	NGO	Non-Governmental Organization
HIPC	Heavily Indebted Poor Country	OECD	Organization for Economic Cooperation and Development
IA	Internal Audit	OMB	Office of Management and Budget
IASB	International Accounting Standards Board	PAC	Public Accounts Committee
ICB	International Competitive Bidding	PEFA	Public Expenditure and Financial Accountability
ICT	Information and Communications Technology	PIP	Public Investment Program
IFAC	International Federation of Accountants	PFM	Public Financial Management
IFI	International Financial Institution	SAI	Supreme Audit Institution
IFMIS	Integrated Financial Management Information System	SOE	State Owned Enterprises
IMF	International Monetary Fund	TSA	Treasury Single Account

USAID	U.S. Agency for International Development
VAT	Value Added Tax
ZPPA	Zambia Public Procurement Agency

I. INTRODUCTION

I.1 The Purpose of the Guide to Public Financial Management (PFM)

The PFM Primer is designed to give USAID field officers a foundational understanding of PFM to empower them to incorporate elements of PFM-strengthening activities into program and project design. Strong PFM systems are critical for the effective, transparent, and accountable use of public funds and underpin good governance. USAID's renewed commitment to government-to-government (G2G) funding, local systems strengthening, and local solutions will necessitate a broader use of partner country PFM systems and greater capacity development to strengthen these systems.

USAID has been involved in strengthening public financial management in many partner countries since the 1970's, with early efforts concentrated in the Latin America and Caribbean (LAC) and Middle East/North Africa (MENA) regions. After the dissolution of the Soviet Union and the adoption of more modern political and economic systems throughout Eastern Europe, substantial assistance was provided to many partner countries, with notable efforts throughout the Baltic States as well as Central and Southern Europe. An assistance modality of integrated fiscal reform projects working with partner governments in the revenue, treasury, and public expenditure sectors, often accompanied by separate projects on accounting, business enabling environments, and trade facilitation was implemented through combined efforts by USAID, the U.S. Office of Treasury Assistance, and other donor organizations. As the states formed on the territory of the former Soviet Union were established, USAID provided similar assistance in most of them, with the notable exceptions of Turkmenistan and Belarus as well as the Republic of Tajikistan, which was rapidly embroiled in a civil war. Progress was uneven, and generally dependent on the openness and political will of the partner countries, but there were some notable reforms and advances.

Substantial USAID efforts in public financial management assistance continued from the 1990's until the present, with added support both to countries in sub-Saharan Africa and to countries undergoing post-conflict and other types of transitions. Importantly, as assistance across a variety of sectors increased, the need for governance systems including PFM to support those efforts and enhance the sustainability of programs has come to be seen as of increasing importance. Succinctly stated, as the proportion of foreign aid to partner country budgets and investment flows decreases, and in support of the international development goals expressed in Paris, Accra, and Busan, the ability of partner countries to manage and finance their own development is essential. Enhanced PFM is a vital tool for both management and finance by partner country governments in that regard.

It is recommended the PFM Primer be used as a desk reference on the general parameters of good practices in each subject area of public financial management. The references and resources cited in each section can be used to guide you to further details and more extensive materials on each topic. The Glossary also provides further definitions for unfamiliar terms. Judicious application of the information available and the references provided should allow for a high degree of rigor in implementation of the program cycle and effective and efficient management, monitoring and evaluation of projects and programming in Public Financial Management. More extensive materials on revenue mobilization are contained in the *USAID Tax Primer* (2012) and the (forthcoming) *USAID Guide to Tax Administration* (2015).

I.2 Structure of the PFM Primer

Sections II through VI of this PFM Primer are structured around the core elements of the PFM system (see Figure 1):

- Budget Planning and Preparation
- Budget Execution
- Public Sector Accounting
- Audit and Evaluation
- PFM Stakeholders

Section VII addresses the sequencing of PFM reforms. Annexes 1 and 2 contain two case studies of specific reform programs and lessons learned. Annex 3 is a listing of categories of expenditures and functions under the UN Classification of the Functions of Government (COFOG) and the IMF General Financial Statistics (GFS) classification schemes. Annex 4 offers guidance on the selection of performance indicators for PFM-related activities along with some sample indicators.

I.3 Additional Resources

Each section highlights the top three reference materials on each topic to be consulted as needed for background and more in-depth information. Additional suggested readings are provided at the end of this document. For assistance in the actual design of programs to strengthen PFM systems in partner countries, please contact the following individuals in the Capacity Building Division of the Bureau for Economic Growth, Education, and Environment Office of Economic Policy:

- **Theresa Stoll, Public Financial Management Advisor**
- **Lawrence K. Daum, Public Financial Management Advisor**
- **Thomas Solomon, Public Financial Management Advisor**
- **Steve Rozner, Senior Fiscal Advisor**

I.4 What Is Public Financial Management?

PFM encompasses the mobilization of government revenue, allocation and spending of resources by public entities, and their accounting and reporting on those revenues and expenditures. In other words, a PFM system includes all the components of a country's fiscal situation and budget process — upstream (strategic planning, medium term expenditure frameworks, annual budgeting) and downstream (revenue management, control, accounting, reporting, monitoring and evaluation, audit and oversight). Sound PFM is an essential (but not sufficient) component of good governance and is vital for the achievement of public policy objectives. Without a robust PFM system, governance will be unsustainable and service delivery will be compromised.

There are three primary objectives for public financial management:

1. Fiscal discipline
2. Efficiency in the allocation of resources (allocation efficiency)
3. Efficiency in the delivery of public services (operational efficiency)

Figure 1: PFM System



I.4.1 FISCAL DISCIPLINE

Fiscal discipline is the ability to control budget totals by setting ceilings on expenditures that are binding at both the aggregate level and on individual ministries, departments, and agencies (MDAs—also commonly referred to as spending units). These are defined as those organizations that receive funds from the consolidated government budget and include the broad array of government organizations that use budget funds to pay for operations, regardless of whether these funds cover 100% of their expenditures. An effective budget system has firm budget totals, rather than accommodating *ad hoc* budget changes that could allow MDAs to overspend. Changes to these budget totals should be restricted by legislation and ideally approved through a consultative legislative process. If MDAs are allowed to increase their budget totals during the budget year to satisfy operational demands, the budget has no validity or purpose.

While this objective seems straightforward, many countries struggle with this level of fiscal discipline. MDAs and the Ministry of Finance (MOF) may increase budgets if inadequate budget execution controls are in place that fail to accurately track expenditures against the budget. Countries will have difficulty maintaining fiscal discipline if politics intrude into the budget execution process, allowing a person in authority to authorize extra-budgetary expenditures or increases in MDAs budgets in violation of legislated mandates.

I.4.2 EFFICIENCY IN THE ALLOCATION OF RESOURCES

Allocative efficiency is the ability of the government to allocate budget resources in accordance with established government priorities defined in strategic planning documents and principles of program fiscal and operational efficiency. The government should be able to reallocate resources from old priorities to new ones and from less to more efficient programs and activities in accordance with government priorities.

There are many reasons why countries struggle to achieve allocative efficiency, including an inability to articulate priorities clearly, a budget process not linked to a strategic planning process, a weak budget execution system that does not force MDAs to adhere to approved budgets, and/or a political environment that empowers some sectors over others in contradiction to stated national priorities. An example of weak allocative efficiency would be a country with health care and education as the government's stated priorities, but a majority of the budget allocated to the military.

I.4.3 EFFICIENCY IN THE DELIVERY OF PUBLIC SERVICES

Operational efficiency is the ability of the government to implement programs at the lowest cost per unit of output while maintaining desired service quality levels. Operational efficiency can be difficult to evaluate. Many governments lack the data to measure the unit cost of a service. While they may know the total cost, the

number of units provided and the desired and actual quality of services might not be clearly articulated or known. For example, what service levels are desired for potable water? Is it having tap water in each house or water pumps located on the street? If street level water pumps are sufficient, what should be the distance between them? Should water be available at all times? What is the desired water quality? The achievement of desired service levels depends both on what the budget can sustain as well as the level of taxes or user fees that the public is willing to pay.

I.4.4 CHARACTERISTICS OF A SOUND PFM SYSTEM

The following characteristics contribute to a sound PFM system that supports good governance:

- 1. Budget credibility:** Is the budget realistic and implemented as intended? The starting point for budget credibility is a realistic assessment of the available resources – or the *resource envelope* - in a medium-term macro-fiscal framework (see Section II.2.4 for further information on macro-fiscal frameworks). Without fiscal discipline and realistic revenue projections, the expenditure budget may be unrealistic and successful budget execution unattainable.
- 2. Comprehensiveness:** Does the budget cover all government fiscal operations, i.e. are all revenues and expenditures “on-budget” thereby facilitating a fully informed policy debate? If the budget is not comprehensive, it will lead to poor allocation of scarce resources because not all expenditures have been included and the legislature cannot compare various programs or establish priorities while considering the budget. It may also lead to misuse and abuse of public resources since there will be no oversight of any extra-budgetary expenditures or funds.
- 3. Transparency:** Is fiscal and budget information accessible to the public? Are comprehensive reports on revenues, budget execution and fiscal planning available and published? Is there a freedom of information law, and is it applied effectively and efficiently to issues of public finance?
- 4. Policy-based budgeting:** Is the budget consistent with government policies and priorities? The link between government policy and the actual allocation of funds in the budget must be established.
- 5. Predictability and control in budget execution:** Is the budget implemented in a predictable manner and are effective control and stewardship exercised in the collection and use of public funds? Budget predictability is an important consideration in donors’ and the private sector’s investment decisions. A medium-term approach to budgeting is critical so the effects of the current year budget can be properly reflected in the following 3 to 5 years. The effectiveness of fiscal controls in fostering budget predictability is an important additional indicator.
- 6. Accounting, recording and reporting:** Are adequate records and information produced, maintained, and disseminated for decision-making, control, management, accountability, transparency, and reporting purposes?
- 7. External scrutiny and audit:** Are there effective arrangements for the rigorous scrutiny of public finances and follow up of audit findings by the legislature and executive?

I.5 Public Financial Management at the Sub-National Level

I.5.1 GENERAL PARAMETERS FOR SUB-NATIONAL PFM

The objectives and characteristics of a sound PFM system are similar at the national and sub-national levels. In general, the PFM practices followed at the national level should be followed at the sub-national level. A country’s PFM legal framework should define the rights and responsibilities of both the national and sub-national governments. The nature and characteristics of those rights and responsibilities depend on the type of

government (i.e., whether it a unitary system¹ or a federal system²) and the preferences of the country's governance establishment. Intergovernmental issues typically addressed in the legal framework include:

- The rights of sub-national governments to collect and retain revenues, the types of revenue collected at the subnational level, and revenue sharing rules or formulas;
- The intergovernmental transfer system, including the types of transfers and sources of funding;
- Reporting requirements from the sub-national governments to the national government and whether sub-national governments must use a central government mandated financial management information systems (FMIS) or can choose their own system; and
- The relationship of sub-national government budgets to the national, central, or consolidated budget.

I.5.2 FISCAL DECENTRALIZATION AND DECONCENTRATION

The most significant aspect of sub-national PFM systems to be considered in PFM reforms is the degree of decentralization, devolution and/or deconcentration permitted under the laws of the partner country. Its primary significance is in the degree of autonomy necessary for effective and efficient PFM operations within sub-national governments. Under republican systems, the level of political and fiscal decentralization is usually substantial, while fiscal decentralization and deconcentration in unitary systems may range from substantial to minimal. A useful concept in this regard is “subsidiarity”, a general principle of European Union Law under the 1992 Treaty of Maastricht and more specifically identified as a guiding principle for local self-government in Article 4, Paragraph 3 of the 1985 Charter of Local Self Government of the Council of Europe. The principle, as applied in the Charter, indicates that any matter should be handled, or service provided, by the level of government authority closest to the beneficiaries that is capable of addressing that matter both effectively and with reasonable efficiency. Significantly, this principle and the Charter are referenced in most discussions of decentralization, devolution and deconcentration.

The following discussion of fiscal decentralization and deconcentration draws heavily on the Decentralization and Democratic Local Governance (DDLG) Handbook, 2007 produced by ARD.

Fiscal decentralization is the legal delegation of revenues and expenditures from national governments to sub-national governments and administrative units. It generally accompanies devolved or some delegated responsibilities. This usually results in an expansion of the resources available to local governments, although it may also be accompanied by increases in responsibilities that increase expenditures. One method used to address the “assignment problem” is matching functional responsibilities to financial proceeds across the various levels of government. Fiscal decentralization directly alters the authority of sub-national officials when it expands their right to collect additional revenues or have an expanded formal role in expenditure decisions. The usual intent of fiscal decentralization is to ensure sub-national governments have sufficient resources and authority to provide legislatively authorized services, or competencies. Fiscal decentralization allows sub-national governments’ greater independent authority to make choices appropriate to their local context and stakeholders within those competencies. The most common types of fiscal decentralization include increasing the transparency and stability of transfers, giving sub-national governments power to collect their own taxes and to set tax rates, and borrow funds with greater independence from the national government. Where local governments are democratically elected, fiscal decentralization can increase both political accountability and

¹ A unitary system of government is defined as one in which sub-national governments are legally subdivisions of a single government whose jurisdiction includes all governmental functions.

² A federal system of government divides jurisdictional powers and competencies between national and sub-national governments and/or organizations, with each having exclusive or semi-exclusive powers within set functions and geographic areas.

transparency. In summary, decentralization ensures sub-national governments have legal authority and resources to implement their competencies in sectors within strictures imposed by national laws, rules, and regulations.

Competencies for service delivery transferred to sub-national governments may include those in visible, high impact sectors; including healthcare, education, and infrastructure. This can facilitate more efficient matching of local preferences and service provision. In applying the principle of subsidiarity, these services should be assigned to a higher level if there are significant scale economies and externalities, but this should be balanced against the imputed enhancements in governance and accountability. Local control of expenditures increases the need for them to impose or be subject to binding hard budget constraints to improve the quality and transparency of subnational spending decisions.

Decentralization can also help ensure that sub-national governments have legal authority to implement their competencies within strictures imposed by national laws, rules, and regulations.

Revenue provision for fiscal decentralization should be based on the following principles:

- Increasing revenue transfers and transferring tax authority from the national to sub-national levels are both important aspects of fiscal decentralization, but delegating tax authority can have more positive effects on accountability. When a larger share of the tax burden is paid at the sub-national level, taxpayers may be more able to hold government officials accountable for the spending of the revenues.
- The assignment of some tax bases to the sub-national levels (e. g., taxes not associated with operations in a locality and taxes like social taxes, which are structured for redistribution) can be inappropriate and lead to more inefficiencies.
- Intergovernmental transfers can be designed to include rule-based definitions of funds available for transfer, transparent and objective transfer allocation formulas, and incentives for sub-national governments to raise local revenues.
- Local government borrowing should be based on an assessment of the government's creditworthiness and the viability of the development projects to be financed.

Fiscal deconcentration differs from fiscal decentralization by retaining key service responsibilities at a higher level of government, but allowing sub-national units to carry out designated roles in providing those services under the authority of higher level institutions. When properly designed, these services are provided with funding transferred from the national government. Deconcentrated funding generally is used to enable sub-national government to execute deconcentrated or delegated responsibilities where decisions about service types, amounts, and qualities are made by the national government. The sub-national governments only have pass-through management authority and funding.

1.5.3 FORMS OF POLITICAL AND FISCAL DECENTRALIZATION: DECONCENTRATION, DELEGATION, AND DEVOLUTION

Decentralization takes three main forms: deconcentration, delegation, and devolution. USAID defines each of these, but focuses on deconcentration and devolution as the two principal forms of decentralization that take precedence in programming:

1. **Deconcentration** may be defined as the national government reassigning responsibilities to the field offices of national ministries without placing these offices under the control of sub-national governments. In other words, deconcentration reassigns authority among different levels of the central government. It can shift operational responsibilities from central government officials in the capital city to those working in regions,

provinces or districts, or it can create strong field administration or local administrative capacity under the supervision of central government ministries. Deconcentration can actually enhance the penetration of national governments into parts of the national territory in which its presence has been marginal in the past, hence its appeal in many post-conflict environments and in fragile states. Although it involves the most limited changes, deconcentration may also constitute the most feasible and desirable set of interventions in various settings. Deconcentration is also an appealing form of decentralization for those services that should not be devolved or should not be fully devolved. These include services where scale or externalities are involved (for example, non-local roads and water resources), or where redistribution of wealth and national standards are important.

2. **Delegation** constitutes a greater degree of change in the distribution of power relative to deconcentration because it shifts responsibility for specifically defined functions to subnational governments or sub-national administrative units. Delegation can be used as a means of building the capacity of sub-national governments and administrative units in preparation for subsequent moves toward devolution. In addition to multipurpose sub-national governments and administrative units, the national government can delegate responsibilities to single-purpose governments and administrative units, parastatals, private firms, and/or nongovernmental organizations. In these cases, delegation moves service delivery closer to people, but not necessarily through sub-national governments.

3. **Devolution** is the most expansive form of decentralization in that it requires sub-national governments to hold defined spheres of autonomous action, which typically necessitates the use of sub-national elections. Thus, unlike deconcentration and delegation, devolution cannot occur in the absence of political decentralization, and for that reason devolution and political decentralization are tightly linked as concepts. After devolution, separately elected decision makers in sub-national governments may be largely independent of the national government, but they are still bound by the provisions of national laws (such as those regarding political rights and civil liberties), national policy priorities (including meeting basic needs and reducing poverty), and national standards (in such areas as fiscal responsibility, healthcare, and water quality).³

II. BUDGET PLANNING AND PREPARATION

II.1 Overview

Budget planning and preparation is the process by which a government develops, approves, and enacts a budget. The budget is the government's current year financial plan and articulates how the government will pay for its programs and ongoing operations.

Budgets may be developed by using various approaches and may have many different technical approaches, but a good budget should articulate the government plans to spend its resources during a given year. To be meaningful, a good budget should not simply list planned expenditures. It should contain sufficient information to enable government officials to discuss whether it is realistic, appropriate, and detailed enough for people to hold the government accountable. It should describe how the government will:

“Top Three” Reference Materials on Budget Planning and Budget Preparation

1. *Beyond the Annual Budget: Global Experience with Medium Term Expenditure Frameworks*. The World Bank Group: 2013.
2. *Public Expenditure Management Handbook*, World Bank: 1998
3. *Best Practices for Budget Transparency*, OECD: 2002

³ USAID, Democratic Decentralization Programming Handbook, 2009.

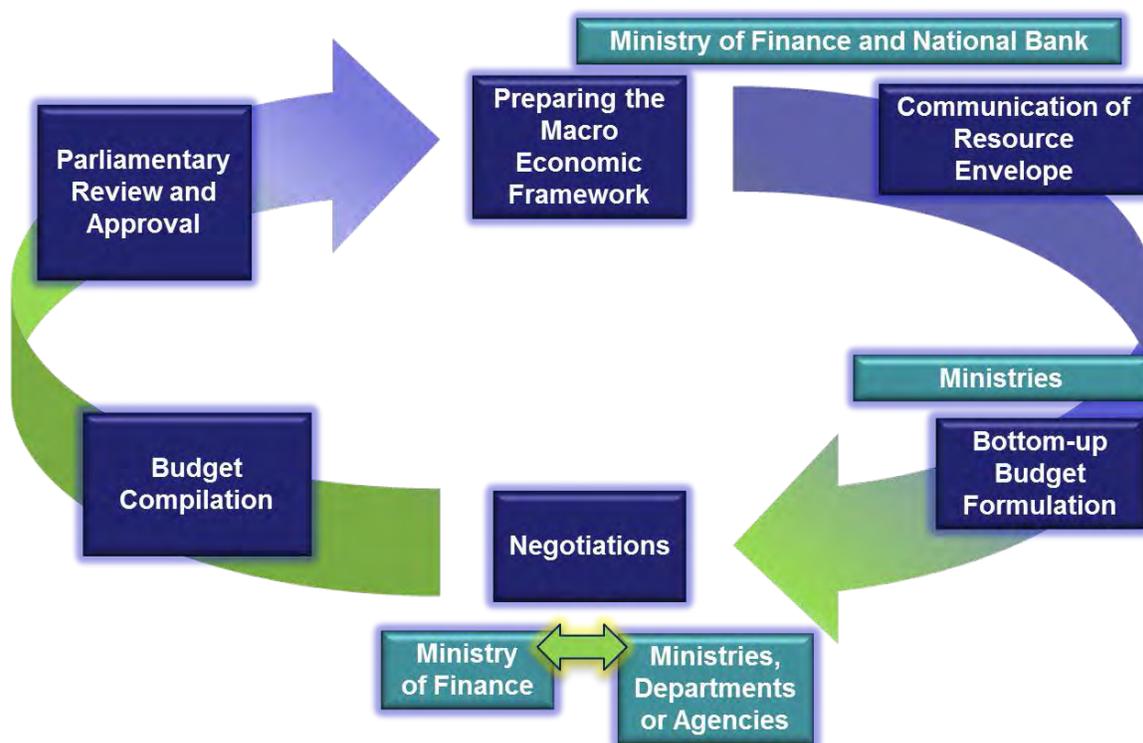
- Generate the needed funds through revenues, borrowing, or user fees;
- Serve its citizens and contribute to a better future; and
- Support national, strategic, and MDA priorities, policies, and objectives through its expenditures.

Many countries have a national strategy that defines the country's long-term vision and a medium-term plan or strategy that describes how the government expects to contribute to progress towards that vision. The budget should describe how the government plans to progress towards achieving this strategy in the current year and, ideally, in summarized form, over the subsequent 2-4 years. To provide a clear articulation of medium-term strategy, the budget should aggregate the plans and priorities of all government MDAs, what services they plan to deliver, and how much each service will cost. The budget development process should facilitate the engagement of a broad range of stakeholders in coordinating plans and priorities for a better future.

Sound financial planning helps governments ensure delivery of the anticipated quantity and quality of services through operations and programs. It results in a realistic and predictable budget that is financially compliant and contributes to macro-economic stability, effectiveness, and efficiency. A lack of sound financial planning hinders stability, efficiency, and effectiveness, and can raise concern among constituents. Reductions in planned expenditures decrease the services that citizens can receive. Too many increases in budgeted discretionary expenditures can raise questions of efficiency and sustainability.

Figure 2 shows the budget planning and preparation process and the involvement of multiple stakeholders. The process begins with the development of a macro-economic framework to help forecast fundamental economic parameters such as inflation, economic growth, and available revenues. Using these forecasts, the MOF or other organizations with budget **planning** responsibilities communicate the resource envelopes to MDAs who develop draft budgets within these funding constraints. The draft MDA budgets are then discussed and clarified through an iterative process between the MDA and the MOF or other organizations with budget **development** responsibility. Then, the draft MDA budgets are consolidated into a draft budget for submission to the legislature. The legislature reviews and approves the draft budget.

Figure 2: Budget Planning and Preparation Process



II.1.1 LEGISLATIVE FRAMEWORK

While each country has its own legislation defining its budget planning and preparation process, there are some general principles to facilitate a functioning budget planning and preparation process.

Legislation should include provisions requiring preparation of an annual budget, guidelines for implementing a centralized budgeting process, and identification of the agency responsible for producing a draft consolidated budget. Although some budget systems include provisions for multiple-year budgets, annual adjustments are often indicated, effectively imparting annual elements to the budget preparation processes.

Examples of legislative provisions governing annual budget preparation include those of the United States, where these provisions are placed in Chapter 11, Title 31 of the U.S. Code (originally the General Accounting Act of 1921). The Code tasks the President with submitting a budget to Congress, defines, among other things, the date of submission and the type of information to be included in the budget, and gives authority to the President to issue regulations with which other agencies must comply. In New Zealand, the Public Finance Act of 1989 (amended 2004) assigns the responsibility for preparing the budget to the Treasury, although budget policy statements with overarching policy goals are the responsibility of individual ministers. In Jordan, the Organic Budget Law No. 58 of 2008 stipulates that the General Budget Department within MOF is responsible for the formulation of the annual budget and the Council of Ministers is responsible for reviewing, revising, and approving the policy statements and the draft annual budget.⁴

⁴ Leo Sommaripa, *Jordan Budget Manual: A Guide to Policy, Process and Analytic Techniques*, USAID: 2012, p. 69, <<http://www.frp2.org/english/Portals/0/PDFs/Jordan%20Budget%20Manual%20English%2027%20Feb%202012%20-.pdf>>.

Example: Fiscal Rules for Balanced Budgets in Canada and the U.S.⁵

Seven Canadian provinces and 49 U.S. States have balanced budget fiscal rules set in legislation. The corresponding legislation specifies one or more of the following:

- Deficit avoidance over a specified period, e.g. the annual budget cycle
- Creation of contingency or stabilization reserves
- Debt repayment guarantees and other commitments for the use of surplus funds
- Regulation of expenditure and taxation; Commitments to consistent accounting practices

Legislation should also define the process by which the budget is enacted and the process to be followed when a budget is not enacted. The provisions of the U.S. Congressional Budget Act, for example, ensure that the budget is enacted in total rather than as a series of appropriation bills. When a budget is not passed, countries clearly define in law whether an interim budget requires legislative approval, such as in Australia and the United States or if, as in France and many other francophone countries, no legislative approval is required. In France, if Parliament does not reach a decision on the proposed budget, the budget may come into force by an executive regulation. In the Philippines, if Congress fails to pass the general appropriations bill, the general appropriations law for the preceding fiscal year is considered reenacted and remains in effect until the general appropriations bill is passed. In the United States, the government must either shut down or approve budgets for specific MDAs through individual appropriation bills.⁶

The budget planning and preparation legislation should also stipulate the fiscal rules that must be followed in enacting the budget. A **fiscal rule** imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules may include limits on the amount of debt that can be incurred, requirements to balance the budget, expenditure limits in absolute terms or growth rates, or revenue-based rules that set ceilings or floors. Not all countries impose fiscal rules, but those that do may use one or more as fiscal control mechanisms.

Examples of Fiscal Rules for Deficit and Expenditure Targets

- The U.S. Balanced Budget and Emergency Deficit Control Act of 1985 specifies declining deficit targets. Other legislation provides limits on discretionary (non-mandatory) programs, limiting mandatory programs to the total of revenues and a deficit limit, or requires the President to cancel non-exempt discretionary programs if caps are exceeded.
- The Maastricht Treaty of 1992 requires European Union member states to limit their budget deficits to 3% of gross domestic product (GDP) and debt to 60% of GDP. Several non-EU countries with aspirations for membership, such as Albania, adopt similar rules.
- In Latin America; Argentina, Brazil, and Peru use overall deficit and/or expenditure targets, whereas Chile has cyclically adjusted indicators. Thus, Chile allows deviations from deficit targets in cases of, for example, economic crisis.

In some countries the general authority for budget planning and, especially, budget approval or enactment, is defined by the constitution. For example, Chapter 7 on Financial Matters of the Constitution of the Hashemite Kingdom of Jordan contains a number of specific provisions related to the budget process including requirements, limitations, and specific processes to be followed.

⁵ Wayne Simpson (n.d.), "The Effectiveness of Balanced Budget Legislation: Lessons from Western Canada", p. 3, <http://www.schoolofpublicpolicy.sk.ca/documents/public_lectures/12.04.30_Wayne%20Simpson_The%20Effectiveness%20of%20Balanced%20Budget%20Legislation.pdf>.

⁶ Parliamentary Strengthening, <<http://www.parliamentarystrengthening.org/budgetmodule/pdf/budgetunit4.pdf>>.

While a constitution may include high level guidance for budget planning and preparation, more detailed rules and procedures are captured in laws and/or regulations. Many countries have detailed budget legislation that prescribes budget responsibilities and processes, such that these are specified in laws rather than regulations.⁷ The Organization for Economic Cooperation and Development (OECD) recommends that budget functions and legal instruments be aligned as follows:

- Laws should delineate responsibilities and issues of the separation of government powers;
- Executive regulations should detail the processes for budget preparation; and
- Parliamentary regulations should detail budget enactment or appropriation.⁸

A few countries have a hierarchy of laws defined in a constitution. These countries, including France and Jordan, allow for organic laws that supersede ordinary statutes; but this is uncommon.⁹ Most countries do not have a hierarchy of budget laws. Usually, either a few key laws (e.g. Australia, Canada, Japan, and Korea) or a single law (e.g. Finland, Kosovo, and Kazakhstan) govern budget processes.

The U.S., Denmark, and Norway are notable outliers. In the first, many budget related laws provide considerable detail on the process. In the latter two, there are no formal statutes to guide the annual planning process.¹⁰ Similar to the rules governing the budget process, fiscal rules are occasionally written into legislation, are often in regulations and occasionally remain unwritten. In many countries, detailed instructions for budget planning and preparation are communicated through executive regulations in the form of the annual budget circular.

II.2 Budget Planning Process

Figure 3 depicts the commonly required inputs for helping a government produce a budget that reflects the economic and fiscal realities as well as the strategic priorities of the country including:

- National development plan/strategic plan
- Macro-economic framework
- Fiscal framework
- Macro-fiscal framework

To provide a comprehensive description of the steps of the budget planning process, the sub-sections that follow describe these inputs individually. In countries with more mature budget planning processes, these inputs are used to develop a medium-term expenditure framework (MTEF) and annual budget, sometimes with excerpts from the national development plan. The MTEF, which is discussed in **II.2.5** below, may be separate from the budget process, but should be closely linked and concurrent. For example, information on the medium-term revenue outlook contained in the MTEF determines the funding available for the government's budget. Importantly, the sector strategies that should be developed as part of a national development plan should also be used as the basis for the detailed sector strategies used in developed MTEF forms such as the medium term budget framework (MTBF).

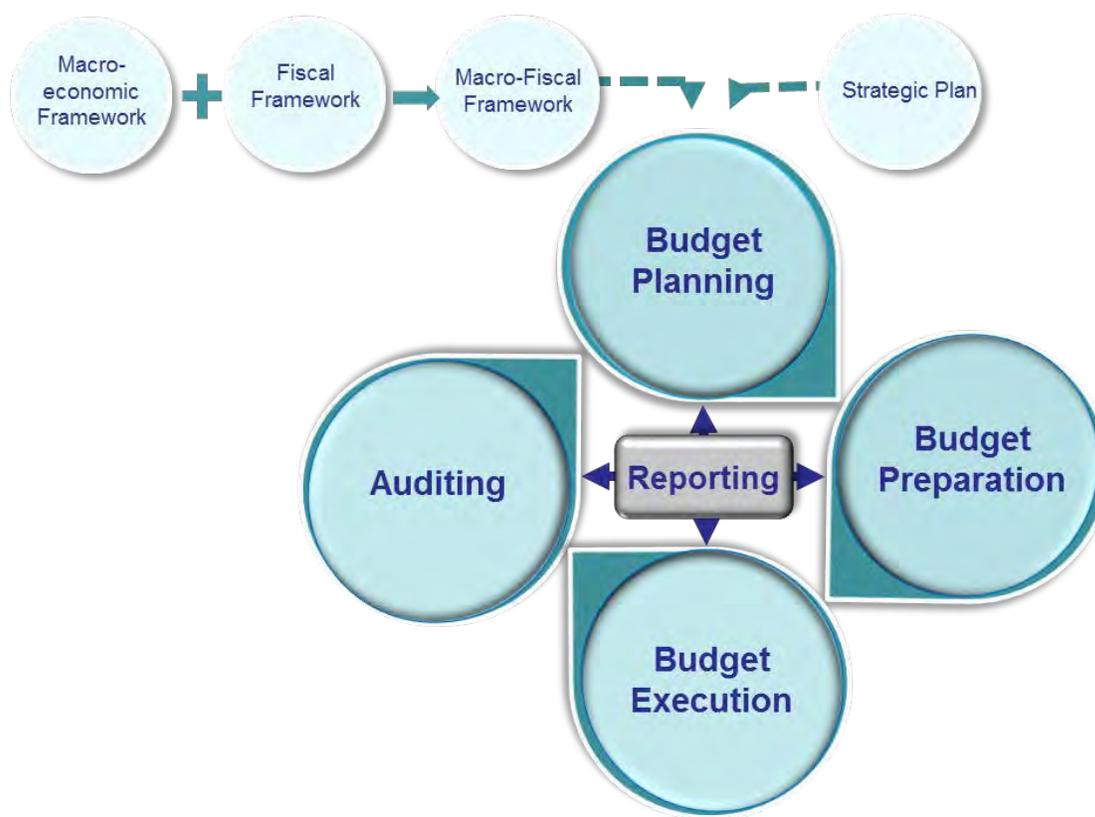
⁷ The Legal Framework for Budget Systems: An International Comparison," *OECD Journal on Budgeting*, Vol. 4, No. 3: 2004, p. 11, <<http://www.oecd.org/gov/budgeting/43487903.pdf>>.

⁸ Ibid, p. 17.

⁹ The Legal Framework for Budget Systems: An International Comparison," p. 27, <<http://www.oecd.org/gov/budgeting/43487903.pdf>>.

¹⁰ Ibid, p. 14.

Figure 3: Inputs to the Budget Planning Process



II.2.1 NATIONAL DEVELOPMENT PLAN

The national development plan identifies the long-term vision of the country and/or its government, usually over 10 years or more, and priorities, policies, and investments needed to progress toward the vision. Ideally, the plans and priorities of all government MDAs should be aligned with national policies and priorities and contribute to achieving the national vision. This alignment is generally accomplished through the development of sector strategies by the MDAs that are then incorporated into the plan. Some budgeting approaches may require MDAs to explain agency goals, how these goals conform to the national priorities, and how progress towards achieving these goals will be measured. The budget itself should be an aggregation of the plans and priorities of MDAs, describing what the government plans to deliver and how much it is expected to cost.

II.2.2 MACROECONOMIC FRAMEWORK

A macroeconomic framework contains an economic forecast for the 2 to 5 year period that defines the short-to medium-term, with projections for economic variables such as GDP, inflation, and unemployment. The macroeconomic framework attempts to realistically assess domestic and global economic trends and forecasts that will result in changes in the national economy. The **economic outlook** refers to the whole set of forecasts. The economy affects both the government's revenue base and the demand for government services and thus the economic outlook is used to estimate the funding that will be available to the government as well as the need for aggregate government spending in the medium-term.

The macroeconomic framework is based on available information and realistic assumptions and is updated continuously as information becomes available and/or assumptions are refined. To the extent that changing policies impact the future economy, the macroeconomic framework should be updated through an iterative process reconciling the various policy objectives.

Key considerations in preparing the macroeconomic framework include:

- Availability of reliable data (economic statistics and census offices)
- Changes in laws and regulations that impact fiscal accounts or the economy
- Global factors that could affect the domestic economy, for example import/export commodity prices; and
- Availability of econometric or other macroeconomic forecasting models and the capacity and/or experience of analysts.

The macroeconomic forecasts should be made public once they are finalized. This allows stakeholders to have information about the government's assumptions, projections, and plans.

II.2.3 FISCAL FRAMEWORK

A fiscal framework (often called a medium-term fiscal framework) contains the **fiscal** (revenue and expenditure) projections over the medium-term and the fiscal position (deficit, balance, or surplus, **fiscal sustainability**, and **fiscal vulnerability**). The fiscal framework reflects government fiscal policy and is informed by the macroeconomic framework. Other important considerations include available data, changes in laws and regulations, and availability of forecasting tools, capacity, and expertise. Changes in government priorities are particularly important to fiscal and especially expenditure outlooks any.

In developing the fiscal framework, governments should consider the following factors:

- **Fiscal position:** The overall budget deficit is often a major fiscal target. It quantifies the amount of money the government plans to borrow from domestic and/or foreign sources to cover the difference between revenues and expenditures in each year. The government deficit is also a fiscal tool during the planning process. In some cases, it will be controlled internally by a fiscal rule such as a deficit ceiling, or externally by global stakeholders, including donors (e.g., an internal legal mandate as in the U.S. Balanced Budget and Emergency Deficit Control Act or a not legally binding one as in Chile; or the externally imposed EU deficit targets not to exceed 3% of GDP for its members to combat recession and potential default by some European countries on their debt);
- **Fiscal space:** Fiscal space describes the government's ability to define its spending. Legislation and the ability of government to borrow may affect the fiscal space. First, legislation may define government programs, including spending. For example, many countries have mandatory spending on health or social security. Second, the flexibility of spending may be limited by the government's ability to borrow as described in the following point;
- **Fiscal sustainability:** Fiscal sustainability refers to the ability of the government to sustain its planned revenue and spending without the risk of defaulting on its debt. A government that faces large amounts of debt as a percentage of GDP also faces larger interest payments as well as, potentially, higher interest rates. The indicators of fiscal sustainability are long-term indicators such as debt-to-GDP and tax-to-GDP ratios; and
- **Fiscal vulnerability:** Consideration should be given to future obligations to reduce vulnerability, including unfunded expenditures and contingent liabilities (e.g., pension contributions).

A good fiscal framework presents the expected developments of future revenues and expenditures and distinguishes between changes in fiscal amounts due to changes in the economy or changes in fiscal policy and priorities. Figure 4 summarizes Canada's fiscal framework for 2013.

Figure 4: Canada's Fiscal Framework for 2013 — Update of Economic and Fiscal Projections (Billions of Canadian Dollars)¹¹

	2012–13	2013–14	2014–15	2015–16	2016–17	2017–18
2012 Fall update budgetary balance	-26.0	-16.5	-8.6	-1.8	1.7	3.4
Revenue effect of adjustment for risk	-1.0	-3.0	-3.0	-3.0	-3.0	-3.0
2012 Fall Update budgetary balance before adjustment for risk	-25.0	-13.5	-5.6	1.2	4.7	6.4
Impact of economic and fiscal developments						
Budgetary revenues	-1.2	-3.4	-3.2	-2.3	-1.9	-2.8
Program expenses ¹						
Major transfers to persons	1.0	1.3	1.1	0.9	1.0	1.2
Major transfers to other levels of government	0.0	0.0	0.2	0.4	0.4	0.4
Direct program expenses	-1.3	0.1	2.5	2.4	2.0	2.1
Total	-0.2	1.5	3.8	3.7	3.3	3.7
Public debt charges ¹	0.5	0.0	0.7	0.5	0.6	0.3
Total economic and fiscal developments	-0.8	-1.8	1.3	1.9	2.1	1.2
Revenue effect of adjustment for risk		-3.0	-3.0	-3.0	-3.0	-3.0
Revised status quo budgetary balance (before budget measures)	-25.8	-18.3	-7.2	0.1	3.8	4.5

Note: Totals may not add due to rounding.

¹ A negative number implies an increase in spending and deterioration in the budgetary balance. A positive number implies a decrease in spending and an improvement in the budgetary balance.

II.2.4 MACRO-FISCAL FRAMEWORK

A macroeconomic framework summarizes information on economic resources, while a fiscal framework uses data from the macroeconomic framework to develop spending and revenue targets. Together these contribute to the development of a macro-fiscal framework. The macro-fiscal framework draws on the macroeconomic and fiscal frameworks to establish a resource envelope that establishes expenditure amounts for a 3-5 year span. These expenditure amounts appear in the medium-term expenditure framework and annual budgets, and are an integral part of the budgeting process and the PFM system. This linkage represents

¹¹ *Jobs, Growth, and Long-Term Prosperity*, Government of Canada: 2013, <<http://www.budget.gc.ca/2013/doc/plan/toc-tdm-eng.html>>.

the best information economists can give to the country about what resources will be available under current law.

Macro-fiscal frameworks sourced in accurate and verifiable data are a vital component in PFM. They are often generated using various econometric models developed in statistical software packages, but if the source materials are inadequate the planning and execution of PFM and government operations are likely to be significantly compromised. It is thus extremely important that the processes used for data collection and manipulation is of the highest quality possible within the local context.

II.2.5 MEDIUM-TERM EXPENDITURE FRAMEWORK

A medium-term expenditure framework (MTEF) is a fiscal outlook document developed from the macroeconomic framework, the medium-term fiscal framework and the national development plan. Essentially, an MTEF is a projection of broad fiscal aggregates (revenues and expenditures) consistent with macro-economic forecasts (inflation and growth) and medium-term policy measures. The MTEF connects available resources and the strategic objectives and priorities of the government in the form of budget ceilings for MDAs. In addition to linking available resources to policy priorities, thus fostering improved planning, an MTEF also provides budget authorities with spending predictability through estimates of available resources for the subsequent 2-4 years.

At a minimum, an MTEF should include the government's policy priorities and a description of the government's vision and broad strategic goals; the economic outlook for the next three-to-five years; the government's policy framework, including any expected policy changes that would impact the fiscal outlook over the next three-to-five years; and a macro-fiscal framework containing *summary* projections of revenues and expenditures, clearly defined assumptions, and risks. Note that such projections should explicitly include recurrent costs and revenues associated with the completion of capital projects and operations of new assets.

Example: Kosovo's First Medium-Term Expenditure Framework

Kosovo's first MTEF was prepared in 2007 by the Kosovo Ministry of Finance with the help of USAID's Economic Management for Sustainability and Growth Project.

- Part I of the MTEF narrates the government's vision as one of "*rapid, sustainable economic growth for the benefit of all the citizens of Kosovo.*" It describes the government's strategic goals: sound economic management, building an effective and efficient state, creating a positive environment for private sector development, supporting key drivers for growth, and developing human resources. It also describes the principle areas of the government's policy focus (establishing mechanisms for transparency, institutionalizing sound policy analysis) within each strategic goal.
- Part II of the MTEF presents Kosovo's macro-fiscal framework. It notes the main features of Kosovo's economy and describes recent developments, medium-term projections, and corresponding assumptions. Projections of the government's revenues, expenditures, and fiscal balance are included, with detail on large current expenditure items, the capital budget, intergovernmental fiscal relations, and financing options. Fiscal risks are also summarized.
- Part III of the MTEF describes the government's sector spending strategies (energy, education, transportation, etc.).

Although the MTEF sets funding amounts, the MTEF does not authorize the government to spend money for the 3-5 year period. Instead, this authorization is provided through the appropriations (or budget) law. The MTEF is a planning document used to engage government agencies and other stakeholders in discussions of policy priorities and financial planning to support achievement of those priorities. The MTEF should be a public document. In some countries, it is voted on by the legislature. In either case, it should be visible to the public and legislature when a budget and the appropriations law have been submitted for enactment.

An MTEF may need to change as national priorities are revised; competing policies are reconciled and as new economic or fiscal information becomes available. Often, the macroeconomic framework and MTEF are periodically updated through an iterative process.

The World Bank notes two other types of frameworks that may be developed.¹² A medium-term budgetary framework (MTBF) builds on the medium-term fiscal framework by including medium-term budget estimates for individual MDAs, reconciling bottom-up determinations of MDA resource needs and the resource envelope. An MTBF allocates resources in accordance with strategic priorities and fiscal objectives at the sub-MDA programmatic increment level. MTBF also should include developed and detailed sector strategies that clearly indicate the policy priorities and choices that must be made by decision-makers. A medium-term performance framework (MTPF) enhances the MTBF with an emphasis on the measurement and evaluation of performance. The MTBF and MTPF are interim steps in a country's advancement towards a full-fledged MTEF.

Figure 5: Medium-Term Expenditure Framework Enablers by Stages

Policy, Budgeting, and Technical Enablers for Different MTEF Stages
<p>MTFF</p> <ul style="list-style-type: none"> • <i>Policy requirements.</i> Set aggregate fiscal targets (fiscal balance, revenue, expenditure) and agency and possibly program expenditure ceilings, consistent with medium-term resource availability. • <i>Budget requirements:</i> <ol style="list-style-type: none"> 1) Legal and administrative framework providing support for an effective cash-based annual budget; 2) Accounting, classification, and reporting: employ cash and, possibly, modified cash accounting, an institution- and, possibly, program-based expenditure coding and chart of accounts, and quarterly reporting on budget developments; 3) Treasury and information systems: ensure that cash flows are centralized, payments are timely, and the flow of financial information is standardized; and 4) Control and audit procedures establishing internal control procedures and external audits to help ensure that spending is in line with appropriations. • <i>Technical requirements.</i> Employ fiscal forecasting, macro-fiscal modeling, and monitoring of fiscal aggregates and their key components. <p>MTBF (over and above MTFF requirements)</p> <ul style="list-style-type: none"> • <i>Policy requirements.</i> Set strategic priorities, both nationally and by sector. • <i>Budget requirements:</i> <ol style="list-style-type: none"> 1) Legal and administrative framework for a move to program budgeting; 2) Accounting, classification, and reporting to employ modified cash or modified accrual account and introduce a program classification (if not in place under an MTFF); and 3) Treasury and information systems and control and audit: adjust to modified cash or accrual accounting and program classification. • <i>Technical requirements.</i> Set up a system of program costing and public investment management. <p>MTPF (over and above MTBF requirements)</p> <ul style="list-style-type: none"> • <i>Policy requirements.</i> Measure performance and link the budget to results. • <i>Budget requirements.</i> <ol style="list-style-type: none"> 1) Legal and administrative framework for a move to performance and possibly accrual budgeting; 2) accounting, classification, and reporting: employ modified accrual or accrual accounting and reporting on program performance; 3) Treasury and information systems to adjust to modified accrual or accrual accounting and require annual reporting on performance; and 4) Control and audit: introduce performance or value –for-money audit. • <i>Technical requirements.</i> Employ performance indicators.

¹² *Beyond the Annual Budget: Global Experience with Medium Term Expenditure Framework*, The World Bank Group: 2013, <<http://www.imf.org/external/np/seminars/eng/2013/fiscalpolicy/pdf/brumby.pdf>>.

II.3 Budget Preparation Process

The purpose of the budget preparation process is to compile the detailed funding needs of government agencies and seek legislative action to set aside the funds for future MDA spending in a fiscal year. It is important to include mechanisms for public and social accountability (e.g., public hearings, public comment periods, participatory budgeting processes, and analysis of gender, environment, and social inclusion impacts).

Generally, the budget preparation process entails the following steps:

1. Dissemination of budget instructions, often referred to as a budget circular, which includes expenditure ceilings based on the MTEF and a budget calendar;
2. Preparation of bottom up budgets by MDAs in accordance with the budget instructions and within the expenditure ceilings set by the MTEF;
3. Submission of draft budgets by the MDAs;
4. Negotiations between the MDAs and the MOF and, ideally, sectoral working groups to reconcile MDA requests and expenditures ceilings defined in the MTEF;
5. Compilation of the budget, which may occur after final legislative approval if considered in parts;
6. Submission of the draft budget to the legislature; and
7. Legislative approval of the budget.

Budget preparation processes that are based on an MTBF or MTPF follow the same basic processes, but the additional layers of detail included in those frameworks should also be evaluated as part of the proposals submitted during the budget preparation process.

II.3.1 BUDGET CIRCULAR

The budget circular is a set of guidelines issued to MDAs by the agency responsible for overseeing the budget planning and preparation process. The individual MDAs must use these guidelines to develop their requests for future funding. It is vital to a successful process that the MOF or other responsible government unit ensures that the budget circular guidelines are followed. A budget circular should describe:

- The government's priorities;
- The laws and policies that govern the budget preparation process;
- The responsibilities of various agencies that oversee the process and may assist individual MDAs during the process;
- The MDAs that should submit a budget request. In principle, the government benefits from a single picture of its financial situation. Budget coverage should be as broad as possible and should include the agencies in the public sector within the control of the specific level of government;
- The information that should be in an MDA's request for funding (estimates of the MDAs own revenue, expenditures, assumptions, justifications, etc.);
- The format for budget preparation;
- The means through which information should be submitted (e.g., through the government's FMIS);
- How expenditures should be estimated. For example, a budget circular typically contains information on suggested personnel cost increases since personnel costs tend to be the most significant item in a MDAs budget;

- The types of justification that should be provided (e.g., program evaluations by the agency or outside groups); and
- The timing of the budget process, especially budget requests.

Example: National Budget Memoranda in the Philippines

In 2012, the Department of Budget and Management of the Philippines issued three budget circulars:

- National Budget Memorandum No. 113 described the government's macroeconomic assumptions, fiscal targets, and budget ceilings for fiscal year 2013.
- National Budget Memorandum No. 114 highlighted the key programs that support the goals of the Philippine Development Plan 2011–2016.
- National Budget Memorandum No. 115 detailed specific budget preparation guidelines (e.g., the classification of government expenditures), the budget calendar, and the forms to be used by MDAs to display data.

The budget circular should be issued early to allow sufficient time for individual MDAs to plan and prepare and for the central budget agency to compile the budget for the legislature. Some countries may issue successive budget circulars to guide MDA staff in preparing their budget. For example, a policy guidance letter may be sent to each agency at the beginning of the current fiscal year for the next fiscal year's budget to assist senior management in MDAs with planning and internal policy guidance. A detailed circular with information on how data should be submitted may be issued a later, often in the next quarter.

Figure 6 provides additional information on the 2012 budget circular of the United States of America. The full document contains over 700 pages and also describes what the budget contains and the roles and responsibilities of the main federal agencies that participate in the budget preparation process (Office of Management and Budget (OMB) and the Congressional Budget Office (CBO)).¹³

¹³ U.S. Office of Management and Budget, *Circular No. A-11*, Washington, DC: GPO, 2012, <http://www.whitehouse.gov/sites/default/files/omb/assets/a11_current_year/s15.pdf>.

Figure 6: Summary Instructions from the Budget Circular of the United States of America¹⁴

- You must provide a written justification when you submit your budget. You should determine specific informational requirements and timing of submissions in consultation with your OMB representative.
- Where possible, you should include the full cost of a program, and you should align budget accounts and program activity lines with programs or the components of the programs that contribute to a single strategic goal or objective.
- Your request should be consistent with the funding levels included in policy guidance. If the request is not consistent with policy guidance, you must provide a summary of what your budget request would be at the policy guidance levels and the reasons why a budget request consistent with the guidance is not appropriate. In addition, you may be asked by your (OMB) representative to identify and discuss the implications of other funding levels.
- Prepare your justification in concise, specific terms and cover all programs and activities of your agency.
- Use tables, charts, and graphs in lieu of, or to supplement, text. Prepare materials in a manner designed to provide all of the information that you and OMB have agreed is necessary for OMB to understand and evaluate your agency's request and make its determinations.
- At the discretion of OMB, you should include the following information for legislative proposals:
 - Your estimates of the costs of implementing or administering proposed legislation.
 - The assumptions underlying your estimates, including new work years, program outputs, and costs of inputs such as materials, contract costs or personnel costs. You should also include a discussion of alternative implementation strategies considered (e.g., contracting out versus in-house), and a discussion of any models used to develop your estimates.
 - The budget classification (mandatory or discretionary) of the costs of implementing and administering the legislative proposal along with a written justification for your selection.
 - Productivity savings and/or offsets for these costs. You should also provide a discussion of the methods and assumptions underlying your estimates for productivity savings and offsets.
- You should also include the following:
 - A comparison of total program benefits and total program costs, using quantitative, objective data to the maximum extent possible, as well as qualitative or judgmental material.
 - A comparison of the marginal benefits and the marginal costs associated with the additional funds or reduced funding proposed.
 - Supporting information that takes into consideration agency and outside (e.g., think tanks, Government Accountability Office, Congressional Budget Office, universities, interest groups) program evaluations and related analytic studies, whether or not they agree with the proposed policy.
- At the discretion of your OMB representative, these requirements may be modified or alternative justification materials specified. It should be emphasized that late decisions on proposed legal provisions for the budget will require flexibility in this process. Other materials may be requested by your OMB representative.

II.3.2 BUDGET CALENDAR

The preparation of the budget for the next fiscal year begins as early as the start of the current fiscal year. Often, a country's budget calendar is specified in legislation. Among the important dates specified in a typical budget calendar are when the budget circular (directions) must be issued, when budget requests are due, and when the budget is due to the legislature. Figure 7 is an illustrative budget preparation calendar.

¹⁴ U.S. Office of Management and Budget, *Circular No. A-11*, Washington, DC: GPO, 2012, <http://www.whitehouse.gov/sites/default/files/omb/assets/a11_current_year/s15.pdf>.

Figure 7: Illustrative Budget Calendar

What?	When?
Policy guidance letter / circular	First quarter of the fiscal year for next-year budget
Discussions of options	Ongoing: First and second quarter
Detailed circular	Beginning of second quarter
Budget requests	Beginning of third quarter
Analysis of budget requests	Third quarter
Briefing to senior officials	Mid third quarter
Agencies informed of budget decisions	Mid third quarter
Agencies appeal and may negotiate	Second half of third quarter
Agencies prepare justification materials for the legislature	Second half of third quarter, fourth quarter
The budget is submitted to legislature	Mid fourth quarter
Legislature enacts broad spending and revenue levels	End of fourth quarter
Legislature enacts an appropriations bill	End of fourth quarter

II.3.3 BUDGET REQUESTS AND NEGOTIATION

After issuing the budget circular, the government agency responsible for overseeing the budget compilation process should engage in discussions with MDAs on budget issues, options, and plans for addressing issues. In complying with the guidelines of the budget circular, MDAs prepare and submit requests for future funding i.e. budget requests. Development of the budget requests should follow the guidance in the budget circular.

The government agency responsible for receiving and overseeing budget requests, often the Ministry of Finance continues discussions with individual MDAs. The MOF may analyze MDA budget requests in light of national or government priorities and may continue to raise issues and present options to MDAs. It will also make decisions to accept or modify budget requests. It may formally announce the end of the process of budget request and supporting data submissions, in accordance with the budget calendar, thus ensuring that sufficient time is available for the final budget document preparation for submission to the legislature. Finally the MOF will also brief senior officials with responsibility for submitting the budget to the legislature (e.g., Minister of Finance, Director of the Budget Department, Prime Minister, or Executive) when a consolidated picture of MDA requests is available and has been reviewed.

After initial MOF decisions on budget requests have been made, MDAs may be allowed to appeal the decisions and engage in negotiations with the central budget authority. An effectively formulated budget circular and carefully developed budget requests will stimulate discussions around the linkages among expenditures, programs, and priorities. Poorly formulated budget circulars and requests may result in discussions of budget ceilings and specific line items, rather than the services to be delivered. Appeals are typically resolved between the central budget authority and the MDA. When resolution is not possible, appeals may be sent up to higher level government officials responsible for preparing the budget submission and submitting it to the legislature.

After budget decisions and negotiations, it is generally the responsibility of individual MDAs to finalize budget justification materials and, in some cases, to explain budget requests to the legislature. While an MDA is preparing justification materials, it should also prepare its detailed budget request data in a format that can be compiled and entered into the government's FMIS.

The preparation of budget requests within the MDA should involve a number of senior and middle-level managers. Historically, the budget process has taken a "top-down" approach, one in which spending priorities

at a significant level of detail are assigned by MOF before budget requests are prepared. This approach has significant drawbacks. Officials establishing the ceiling limits may be somewhat removed from the day-to-day budgetary challenges of implementing policies and procedures. As a result, the budget might not adequately reflect the resources needed. Under a bottom-up approach the budget is created by MDAs following budget ceilings provided at a higher level and guidance provided in the budget circular and submitted back up to the MOF or central budgeting authority. With this approach, MDAs build their budget by compiling inputs from middle managers. Bottom-up budgeting may also have drawbacks because managers may overestimate the resources needed in anticipation of potential cuts during the review process. Since line managers may view things from the perspective of their individual programs, little appreciation may be given to the big picture challenges of allocating resources for the entire country. Carefully formulated budget ceilings provided to the MDA and a well-defined budget preparation process that keeps MDAs within the ceilings except where increased budget requests are well justified will help control this problem.

II.3.4 TYPES OF BUDGET APPROACHES

While all countries prepare a budget, the format and approach to budgeting may differ. Usually, the budgeting approach should depend on the highest priority budget objective (fiscal discipline, allocative efficiency, or operational efficiency) and the capacity of the central budget agency and budgeting staff of the Ministries, Departments, and Agencies. Until recently, the primary focus of national budgeting has been control over public resources. However, this focus is changing. Many countries have moved beyond line-item budgeting to program or performance budgeting. The budget circular defines the approach that MDAs must use. Four approaches to budgeting and their relative merits are described below:

- **Line item budgeting:** Each MDA's revenue sources and major items to be purchased during the fiscal year are listed. Historically, the line-item budget has been the most widely used budgeting approach because it is relatively easy to prepare and requires limited financial skills. The simplicity of the approach also allows for officials to easily monitor revenue and expenditures. The major deficiency of line-item budgeting is the difficulty determining the results generated as a result of resources expended. It is also difficult to establish priorities and determine the quantity or quality of services that could be provided at various expenditure levels.
- **Program budgeting:** Agencies are asked to identify the total cost of each program and set spending limits and priorities. Program budgeting shifts the focus away from how much money was spent to how the money was spent and what was achieved. One downside, however, is that programs tend to overlap within and across MDAs, making the allocation of resources and collection of data difficult without structured interventions to assure quality data for decision-makers.
- **Performance budgeting:** The budget of each program is combined with performance information. Specific goals and objectives are tied to expenditures for each program. The focus is on what will be accomplished with the resources provided. Performance budgets provide an advantage in the design and implementation of monitoring and evaluation mechanisms for projects by setting initial parameters and metrics. The main disadvantage of performance budgeting is the considerable resources required to develop reliable measurements as well as the cost and scarcity of skills needed for performance measurement. Carefully phased assistance is often necessary, since this is quite difficult to execute properly and is rarely used in USAID partner countries.
- **Zero based budgeting:** Conventional budgeting **tends** to perpetuate the current level of funding, focusing on adjustments for inflation and justifications for incremental changes. By contrast, the zero based approach does not assume that existing programs will be continued indefinitely. It requires all MDAs to justify the entire level of funding for their programs each fiscal year. Zero based budgeting can

be combined with any of the other above approaches. Budgets are established based upon what is needed for the upcoming fiscal year, regardless of whether the budget is higher or lower than prior allotments. The MDA must also reflect the various levels of service that could be provided at different funding levels. The justification document can also be used to reflect the effects of the various, possible funding levels (e.g., maintaining the current level, reducing funding by a certain percentage, or increasing funding by a certain percentage). A downside to zero-based budgeting is that it is resource intensive and as a result is rarely used. It can also have a negative effect on the continuation of program funding priorities unless effective controls are kept in place.

The above budgeting approaches reflect advancing levels of maturity and complexity in a budgeting process, with each approach serving as a building block for the successive level. Line-item budgeting provides the platform for all other budget approaches. For instance, a program budget is still developed through a line item budget, but cross-cutting information is presented for programs, rather than MDAs or their sub-units to provide a clearer picture about how the money would be spent. For example, if a university budget is developed using the line-item approach it will include the cost of labor and other direct costs for the university as a whole. However, if the university uses a program budgeting approach, it will present the labor and other direct costs separately for each department such as engineering and business; or sub-departments such as mechanical engineering and civil engineering. Regardless of the level of budget disaggregation, specific line items, such as labor or other direct costs, still serve as the basis for formulating a program budget.

Performance budgeting goes further than program budgeting by estimating the results that can be achieved by each program and the funds expended. For example, each type of mechanical engineering program may set targets around the number of students, the cost per student educated, and the ratio of public to private funding. Figure 8 provides additional detail on each budgeting approach. While line item budgeting was widely used in the past, contemporary approaches put a greater emphasis on programs and performance.

An approved establishment list indicating the authorized staff positions is an important part of the budget or a supplemental document. It should reflect vacancies to be filled and savings or cost increases resulting from normal staffing turnover. These may be reflected in the budget or a supplemental document. This list indicates what positions are authorized and budgeted for, and may include modifiers to account for the vacancy and turnover savings resulting from normal staffing changes during a budget year without compromising the position lists.

Figure 8: Comparison of Budgeting Approaches

Type Budget	Purpose	Characteristic	Success Factors	Advantages	Disadvantages
1. Line Item	<ul style="list-style-type: none"> a. Spending resources according to plan b. Reduce risk of misappropriation of funds c. Promote financial accountability 	Focus on prior year allocation as starting point	Minimum amount of staff time and expertise needed to create and track the budget	Works well when time is short and there is considerable complexity, with multiple stakeholders and a high potential for conflict	Not well-suited for dealing with questions of efficiency, effectiveness, and future and/or previously neglected concerns. Tends to become additive and discourage major changes
2. Program	<ul style="list-style-type: none"> a. Ensure that programs are achieving goals and objectives b. Promote accountability 	Focus on program plans, goals, and objectives	Requires the resources necessary to develop program plans, goals, and objectives	Provides a clear linkage among program activities, budget allocations, and government priorities	Requires considerable resources and has a high potential for conflict due to varying interpretations between MDAs
3. Performance	<ul style="list-style-type: none"> c. Ensure that programs are effective (generating results) and efficient (least-cost) 	Performance measurements utilized to determine efficiency and effectiveness	Requires considerable resources to develop reliable measures and time to develop the skill sets of those responsible for developing measurements	Provides an objective way of documenting accomplishments, and there are linkages to government achievement of goals, objectives, and priorities	Time-consuming and expensive, with a high potential for resistance because of fear that performance measures would be used to reduce funding. Creates incentives for distorted reporting of performance.
4. Zero-Based	<ul style="list-style-type: none"> a. Annual assessment of whether programs and functions should be continued d. Focus on priorities and detailed input projections 	Annual evaluation of current program activities	Requires considerable time and resources to assess all programs annually and articulate justifications	Provides an opportunity for activities to be evaluated annually and an opportunity to reallocate resources	Places a high burden on organizational resources and difficult to achieve comparability across organizational units

II.3.5 CAPITAL BUDGET

The capital expenditures refer to investments to acquire, construct, or repair assets with an expected life of greater than one year, including land, buildings, facilities, equipment, vehicles, and other infrastructure. In budget planning, capital expenditures do not necessarily have to be treated differently than expenditures for personnel, supplies or other operating costs. However, capital expenditures are often placed in a separate section of the budget called the capital budget for the following reasons:

- A common and appropriate financial management practice is to fund capital expenditures through the issuance of obligation bonds. Legislation may limit the term of bonds or significantly restrict how these funds may be spent;
- Capital expenditures can sometimes be deferred more easily than operating expenses; and
- Since capital assets can be costly and time consuming to construct, their acquisition may span several budget cycles and risks of large cost over-runs may be high. In addition, the impacts of capital expenditures are long-lived and may not be immediate. Consequently, governments should ensure that:
 - Capital budgets are in line with government priorities;
 - Assets have a projected return on investment equal to or better than alternative uses of funds. All costs and completion schedules should be carefully estimated and measurable performance goals should be set. Capital investments are often amenable to cost-benefit analysis or cost-effectiveness analysis, and the adoption of formal required cost-benefit/effectiveness analysis processes for capital budgeting is recommended;
 - The risks associated with the assets are understood and managed at all stages;
 - The acquisition is implemented in phased, successive segments, unless there are significant economies of scale with acceptable risk by funding more than one segment or there are multiple units that need to be acquired at the same time;
 - Steps are taken to accommodate spikes in financing; and
 - Cost, schedule, and performance goals are controlled and monitored and there is a formal review process to evaluate whether the acquisition should continue or be terminated if issues arise.¹⁵

Capital investments often have implications for future operating, maintenance, and replacement costs. Changes in operating expenses, including personnel, debt service, taxes, or other operating expenses associated with capital investments should be included in budget submissions for future years. These recurrent costs associated with capital projects or initiatives may constitute significant future expenditures that are not intrinsically associated with the projects when capital budgets are separate and/or accrual accounting procedures are not followed. Integrating the capital budget into the annual budget process, medium term expenditure frameworks, and other budget documents is a proven methodology for capturing these future costs in a way that provides information to decision-makers and is vital for fiscal accountability when budgets cover a 3 to 5-year medium term.

¹⁵ U.S. Office of Management and Budget, *Circular No. A-11*, <http://www.whitehouse.gov/sites/default/files/omb/assets/a11_current_year/s15.pdf>

II.3.6 PUBLIC INVESTMENT PROGRAMS

A public investment program (PIP) can help guide capital investment decisions and implementation for better planning and execution over a 3-5 year or longer period. A PIP may also facilitate leveraging and management of donor and private sector financing.

The PIP can help in setting priorities for future projects and tracking future costs of multi-year capital projects. The PIP should estimate the current costs for operation, maintenance, and replacement of capital assets and the government's ability to fund them. The potential risk of a PIP is that it can create a dual budgeting approach that separates the capital budget from the regular operating budget. It could also result in a greater focus on the project rather than the program. The World Bank recommends the following practices when a PIP is used:

- Develop plans that are realistically cost constrained, by proceeding sequentially from the macro framework to sector resource envelopes and then to selection of priority policies and programs within sector constraints;
- Ensure that objectives, policies and expenditures are linked in each sector;
- Link the PIP with regular budget procedures and coordinate the PIP with ongoing budget and accounting reforms; and
- Enforce discipline in the use of aid.¹⁶

II.3.7 BUDGET APPROVAL

The central budget authority presents the consolidated budget to the legislature for further review and approval (often through the executive branch). The legislature will review, comment on, and even revise the budget prior to approval. In some cases, the legislature may request verification information from fiscal or sectoral analytical units (such as the Congressional Budget Office in the United States of America or any integral fiscal or sectoral analytical units) The budget is typically analyzed by various legislative committees. In many developed countries, the legislature will often vote on the budget at least twice: once to accept the summary fiscal plan (MTEF) and one or more times during the year to set aside funds for spending (appropriation bills).

Necessary Controls in the Budget Preparation Process

- The primary controls in budget preparation are the applicable legislative arrangements that assign responsibilities to specific government agencies, describe the budget process, and define specific fiscal rules.
- Most importantly, the budget preparation process benefits from the central role that one specific government agency (e.g., MOF) plays in reviewing budget requests and developing the final consolidated budget.
- The budget preparation process should be regulated through a transparent process and subject to stakeholder scrutiny.

Typically, the rules, processes, and procedures to be followed in the legislature's review, consideration, and approval of the budget are set in the legislative rules. To promote civic involvement, legislative committee deliberations on budgets should be open to the public and the media. Some

¹⁶ The World Bank, Public Expenditure Management Handbook, 1998, Page 57.

legislatures hold additional public hearings at the national and/or sub-national levels to receive public input before budget approval. Public outreach can be facilitated by the release of a summary budget document by the executive branch at the time of submission to the legislature. This shorter and easier-to-read document is often called a "Budget in Brief."

The legislature prepares an appropriations bill based on the consolidated budget request and any subsequent changes made by the legislature. An appropriations bill lists the amount of funding available for a program or agency over the budget period. There may be multiple appropriation bills in a single year (as in Canada, and New Zealand) or a single appropriation bill covering all MDAs.

The following are examples of how various legislatures review and approve draft budgets:

- In Canada, the Minister of Finance presents the budget, actually an MTEF, to the House of Commons. The MTEF states the government's priorities, fiscal outlook, (revenues, expenditures, and debt), and major fiscal actions planned for a five-year period. After Canada's Parliament votes on the budget, it votes on an Appropriation Act (called the "Interim Supply"), which allows individual departments to spend 3/12ths of their annual budget. This partial authorization enables Parliament to spend more time in examining the MTEF and the underlying estimates.¹⁷ Later during the year, Parliament votes on a second appropriation bill, called "Full Supply."
- The United States Congress first adopts a budget resolution that specifies total receipts and outlays and major categories of spending. Each step in this process begins in the lower body, the House of Representatives, and is then forwarded to the Senate for review and approval, while any disagreements are resolved in a bicameral conference committee responsible for reconciling the different versions, and the bill is then transmitted to the President for signature. The budget resolution is a concurrent resolution that binds Congress, but does not have the force of law and does not require presidential signature. Subsequently, the Congress enacts legislation authorizing changes in direct spending programs and in taxes consistent with the budget resolution. After the concurrent budget resolution and spending and tax legislation changes, the US Congress enacts program specific "authorization" bills to establish the legal basis for programs that are not already in place. The authorization bills provide no funding. The subsequent authorization bills allocate funding and are approved by different committees than the authorizing committees. A single appropriation bill funds annual non-mandatory (discretionary) programs. The appropriation bill is usually thought of as the U.S. budget.
- Until 2006, the Government of France presented a draft government budget to Parliament in, a single document that included a fiscal outlook. Starting in 2006, French law required dividing the budget by major policies or programs. Currently, the French Parliament votes on approximately 30 separate appropriations bills known as "missions".
- In the Philippines, the House of Representatives reviews macroeconomic assumptions and individual MDA budgets, and then undertakes three readings and enactment of a single General Appropriations Bill. The bill is then forwarded to the Senate. A bicameral conference committee) is responsible for reconciling different versions, and then to the President for signing.¹⁸
- Figure 9 shows typical programmatic entries in the Appropriations Bill of New Zealand and how these are presented to the Parliament.

¹⁷ Jobs, Growth, and Long-Term Prosperity, Government of Canada, <<http://www.budget.gc.ca/2013/doc/plan/toc-tdm-eng.html>>

¹⁸ *The Budget Process and the Philippine Congress*, The Hrep Reference Librarian, <<http://hrepreflibrarian.wordpress.com/2013/03/07/the-budget-process-the-philippine-congress/>>.

Figure 9: Extract of New Zealand's Appropriation Bill, FY2012/2013¹⁹

Vote	Page Reference in Supplementary Estimates (B.7)	Appropriation	Expenses or Capital Expenditure \$(000)
Accident Compensation Corporation	2	Departmental Output Expenses:	
		Policy and Related Outputs	(286)
		Regulatory Services	2
Arts, Culture and Heritage	10	Departmental Output Expenses:	
		Delivery of Going Digital Program	(140)
		Heritage Services	1,385
		Policy Advice, Monitoring of Funded Agencies and Ministerial Services	(241)

II.3.8 SUPPLEMENTARY BUDGET

A supplementary budget is the outcome of a formal process to approve changes to an enacted budget, including the appropriation of additional funds. During the fiscal year, the government should develop a revised budget that reflects changes in economic assumptions, legislative changes, and technical changes or corrections and submit it to the legislature for approval. Some countries, such as the United States of America, require Congressional and Presidential approval of supplemental appropriations.

Other countries have legislation that allows MDAs to make changes within their budgets without legislative approval as long as the changes are within specified parameters. In South Sudan, MDAs are allowed to transfer funds up to 10% of the budgeted amount from one line item to another within a chapter (where chapters are salaries and allowances, operating expenses, and capital expenses) simply by notifying the Ministry of Finance and Economic Planning. In Nepal, MDAs are allowed to transfer funds between line items up to 25% within a program, but cannot move funds out of salaries, capital subsidies, furniture, transport means, machinery, or tools.

Even where MDAs are allowed to make such changes, it may be a good practice to secure *a posteriori* legislative consent to these changes. MDAs or the MOF may present a summary of the changes justifications to a specific sub-committee of the legislature (usually comprised of members of financial and/or fiscal committees) or through incorporation in the supplemental budget. To avoid conflicts between the legislature and executive branches, the countries' laws prohibit retroactive changes to expenditures that have already been legally made. In these countries, a supplementary budget is required

¹⁹ "Appropriation (2012/13 Supplementary Estimates) Bill," Government of New Zealand: 2013, p. 9, <<http://www.legislation.govt.nz/bill/government/2013/0114/latest/versions.aspx>>.

for any changes beyond the legally allowed parameters and to provide additional funds for new programs and higher expenditures than expected for well-justified reasons (e.g. an economic down-turn requires larger unemployment benefits than originally budgeted), inflation adjustments, or to cover shortfalls in user fees or other non-appropriated revenues collected or expended by individual MDAs.

The central budget authority typically issues formal guidance on how to request supplementary funding and/or changes to an MDA budget as well as a calendar for development, submission, negotiation and consolidation of these requests. The supplementary budget is then submitted to the legislature for formal approval. Most countries pass at least one supplementary budget per year and some (such as Sweden) have more than one supplementary budget per year.

II.3.9 TRANSPARENCY

A transparent budget is openly communicated to the public with sufficient detail and clarity to enable the government to be held accountable for services. A transparent budget allows the government to engage stakeholders in budget implementation, which, in turn, helps to ensure that policy objectives are achieved.

The OECD defines budget transparency as "the full disclosure of all relevant fiscal information in a timely and systematic manner." It also proposed the following guidelines for the budget planning and preparation process:

- The budget should be comprehensive (including all government MDAs, expenditures authorized in permanent legislation, earmarked revenues, capital, and PIP expenditures);
- Sufficient time and information should be provided to the legislature to review and enact the budget;
- The budget should include a medium-term perspective, rather than being limited to a single year, and deviations from previous year forecasts should be explained;
- The budget should include performance information;
- The budget should distinguish between earmarked revenues/mandatory programs and discretionary spending;
- Economic assumptions, revenue projections, tax expenditures, and agencies' own revenue should be presented separately, generally in an MTEF. A sensitivity analysis of assumptions is preferred;
- The government's assets and liabilities, including non-financial assets, contingent liabilities, employee pension obligations, etc., should be presented, preferably separately for each type of asset and liability;
- The government's priorities and economic and fiscal outlook and assumptions should be presented before the budget, early enough to encourage discussions on the budget;
- In the middle of the fiscal year, the government should develop a revised budget (supplemental budget) that presents the same information as above, as well as the impact of changes in economic assumptions, legislative changes, and technical changes;

- A report similar to the mid-year report should be presented before elections, although the feasibility of such a report may depend on the constitution or other legislation;
- At least once every five years, the government should analyze the long-term sustainability of current policies and should publish this information;
- Accounting policies should be summarized and presented and the same policies should be used for all reports; and
- Each report should contain a statement of responsibility by the senior official responsible for producing the report.²⁰

II.3.10 RESPONSIBLE PARTIES

Countries may assign responsibilities for budget preparation across one or more agencies. These responsibilities include:

- **Developing and communicating macro-fiscal frameworks and MTEF.** This task is generally assigned to a macroeconomic unit within the MOF or Ministries of Economy or Planning.
- **Assisting the senior government official responsible for submitting the budget to the legislature during budget preparation.** In the U.S., the President submits the budget to Congress and OMB prepares the budget submissions. OMB evaluates the effectiveness of agency programs, policies, and procedures, assesses competing funding demands among agencies, and sets funding priorities. OMB also ensures that agency reports, rules, testimony, and proposed legislation are consistent with the budget and with policies of the executive branch. In most developing countries, this role is played by MOF or Ministry of Planning and is the core of the budget preparation process. Additional assistance is provided at the MDA level by staff and management responsible for budget preparation.
- **Assisting the legislature during budget enactment.** In the U.S., CBO was created by the Congressional Budget and Impoundment Control Act of 1974. CBO's mission is to provide Congress with objective, timely, non-partisan analyses for economic and budget decisions and the information required for budget enactment. CBO prepares analyses and estimates on the budget and the economy and presents options and alternatives for Congress, but does not make policy recommendations. Most developing countries do not have this type of institutional support for the legislature and rely on analyses from the Ministry of Finance or Ministry of Planning and parliamentary staff and committees to provide this type of support.

In many countries, all responsibilities above fall within a single government agency, typically the Budget Department within the MOF. This agency also often monitors budget execution and adherence. One disadvantage of this arrangement is that the need to keep up with the significant amount of processing required to monitor the budget may take attention away from policy, priority, and performance analysis.

²⁰ "Best Practices for Budget Transparency," OECD: 2002, <<http://www.oecd.org/governance/budgeting/Best%20Practices%20Budget%20Transparency%20%20complete%20with%20cover%20page.pdf>>.

II.4 Common Challenges

Common challenges during budget planning and preparation include:

- Lack of capacity in the government agency responsible for overseeing the budget planning and preparation process and in individual government MDAs;
- Short budget calendar or non-adherence to the budget calendar
- Lack of budget comprehensiveness

II.4.1 LACK OF CAPACITY

A primary challenge in implementing a proper budget planning and preparation process is the lack of capacity, both within the agency responsible for overseeing the planning and preparation process and the MDAs requesting funds. When one agency is responsible for both producing the fiscal outlook and compiling the detailed budget requests, there is a risk of too much focus on budget preparation relative to analysis of the macro-fiscal framework. In some countries, the central agency has more of the characteristics of an accounting agency and limited capacity for policy analysis at the summary level needed for the MTEF or the program or agency level. Within MDAs, there is often significant variability in staff capacity to prepare budget requests. Some staff might not understand the concept of a program the relationship between their operations and government priorities, and performance based budgeting. If the legislature receives limited policy analysis support, it may hinder its ability to allocate resources in accordance with government policies.

II.4.2 ABBREVIATED PREPARATION TIMELINE

In many countries, capacity challenges are exacerbated by a short budget preparation calendar or lack of adherence to the legally mandated budget calendar. Even when the budget calendar is appropriate, it is not necessarily followed at the central and/or sub-national levels. Or the budget authority may be late in releasing a budget circular, thereby truncating the budget preparation timeline. Under a short timeframe MDAs may be forced to reduce the involvement of mid-level managers in the budget process, focus on top-level budget ceilings, or fail to justify their priorities well in the budget request. Lack of technology contributes to this problem because of the significant amount of manual work that MDAs must perform while developing budget requests. Without a centralized FMIS that includes a budget preparation function, the central budget agency may have to handle significant format variations in the budget requests even if there is a clear budget circular. Manual processing may also divert attention from discussion of national priorities.

II.4.3 BUDGET COVERAGE AND OFF-BUDGET OPERATIONS

Many countries place certain government agencies, programs, or operations outside of the central budget and free them from government salary scales and personnel rules. This may be done to address staff capacity constraints in high priority programs; to reduce the visibility of operations considered as

unrelated to the primary programs of an entity, or for many other reasons. This approach has the drawback of reducing the comprehensiveness and transparency of the national budget, and the ability of the government to manage its money while simultaneously reducing accountability. There may be a temporary and limited justification for off-budget activity in failed or post-conflict states, and this is often the subject of international financial institution and/or donor analysis and agreement with partner governments. However, good practice calls for countries to transition away from these practices as soon as practicable.

Off-budget operations may fall into a number of categories. Examples may include power, telecommunications or other utilities, commercial or profit-making enterprises, entities whose operations are funded wholly or in part from specific revenues generated as a result of their activities, or even significant MDAs that are separated from central government operations based upon historical or other reasons, such as a central bank. It is advisable, once it has been determined that there are off-budget operations, to discuss this with the responsible parties in partner country governments, local offices of international financial institutions, CSO, and other donors to determine their provenance and justifications for those operations. Programming to assist in eliminating off-budget entities may include privatization; incorporation of organizations, staff and budgets into public budgets; or the elimination of those activities and/or functions.

State owned enterprises (SOEs, also known as parastatals) may continue to be necessary and are generally treated differently than MDAs in the budgeting process. A state owned enterprise is an entity in which the national, provincial, or local government has a controlling or minority ownership interest that allows it to exercise full or partial management control. SOEs have their own revenues and might or might not receive appropriated funds from the consolidated budget. An SOE will generally have more independence and flexibility in budget preparation and execution than an MDA, as long as certain conditions are met and controls in place to minimize the financial burden on the government. In general, the more commercial the SOE, the more flexibility it will have. If an SOE is producing a good or service that is or could be profitable and there is no market failure or special public purpose served, then leading practice suggests that this undertaking should be a private sector business. Many SOEs do not operate in a competitive environment due to policy restrictions that have unfavorable effects. Also, SOEs are sometimes unprofitable due to inefficiency, but could be profitable if privatized.

SOEs can be divided into three categories:

1. Departmental (an SOE legally designated as wholly owned by the government; e.g. post offices and state-owned railroads);
2. Statutory Corporation (an SOE created by legislation and controlled by government but with additional ownership by others; e.g. public airlines or banks); and
3. Joint Stock Company with shares owned by the state and non-state entities (e.g., many utilities).

The classification of the SOE will affect how it is included in the budget process and the extent of the management controls exercised by the government. While the approach varies across countries, a **departmental SOE** will generally be included in the budget and have less autonomy than a joint stock company. A departmental SOE may receive a direct budget subsidy from the government based on a budget developed and negotiated with the central budget office and approved by the legislature. In exchange for the subsidy, the SOE may receive direct policy targets from the government. A **statutory corporation** may have its' budget split between budget-funded and enterprise-funded expenditures and revenues, partaking of the characteristics of both other SOE types in terms of government controls, and usually will have a board of directors that have significant independence in

policy and operations. A **joint stock company** generally operates entirely from its own revenues without a direct subsidy. Governments may provide a guarantee for loans incurred for any type of SOE.

SOEs may be subject to a political burden to hire redundant or inefficient labor and provide social services. They may be allowed them to operate within soft budget constraints, leading to inefficiencies, low productivity, and financial losses. Over the last two decades, many countries have implemented reforms that imposed accounting and financial reporting standards on SOE and forced them to face hard budget constraints.

II.5 Implementing Reform

Budget planning and preparation reforms should focus on strengthening the links among policy making, planning and budgeting to make the budget more credible, accurate and realistic. The primary focus areas should be institutionalization of accountable, iterative and inclusive budget development processes and making the linkages between policy, performance, and government service delivery explicit. The substance and sequencing of such reforms is discussed in more detail under VII, below, but a good practice tool of proven effectiveness in achieving development outcomes is the MTEF.

The MTEF was developed specifically to address these shortcomings in the budget process. Although more than two thirds of countries around the world have a type of MTEF, their success and impact on budget management and fiscal performance vary significantly. Common problems with an MTEF include insufficient attention to basic aspects of budget management and inadequately addressing political and institutional realities. In countries where an MTEF is performing poorly, or is underdeveloped, reform should focus on:

- Improving budget realism by improving revenue and new borrowing forecasts;
- Allowing spending to be driven by medium-term sectoral strategies based upon those used for the national development plan, rather than incrementally increasing annual budgets without reconciling them with national priorities;
- Empowering spending agencies with a voice in the design of sector strategies and flexibility to managing their resources. Effective sector strategies linked to the national development plan are vital to the success of PFM systems, and must be developed by MDA, optimally with stakeholder inputs;
- Linking budget allocations to performance and results; and
- Greater fiscal transparency and accountability about government performance against approved plans to hold the government accountable for fiscal policies.

To capitalize on the potential benefits of an MTEF (longer-term planning, enhanced fiscal discipline, and better prioritization of spending and policies), reforms should improve adherence to budget constraints. Budget ceilings should be enforced and MDA spending constrained accordingly. In countries that do not use an MTEF, it may be advisable to take an incremental approach by first adopting a Medium-Term Fiscal Framework (MTFF), followed over time by a Medium-Term Budget Framework (MTBF) and then a Medium-Term Performance Framework (MTPF) to fully develop an MTEF. The adoption of an MTBF or an MTPF also helps in setting priorities for expenditures and encouraging policy-makers to allocate scarce resources in accordance with national and sector strategies and performance. Table 1 summarizes good practices for an MTEF.

TABLE 1: Guide to MTEF Good Practices²¹

MTFF

- Debt and deficit targets are established using model-based debt sustainability analysis, taking into account constraints imposed by policy rules.
- Revenues forecasts are based on revenue department or other tax and non-tax receipt models.
- Independent macroeconomic forecasts are used, and fiscal forecasts are subject to scrutiny by an audit office, fiscal council, or similar consultative body.
- Aid commitments are covered by debt sustainability analysis and revenue forecasts.
- The Ministry of Finance issues a background paper on macro-fiscal objectives to inform budget decision making and form part of the budget documentation.

MTBF

- The MOF issues a budget strategy paper describing the macro-fiscal framework and providing a board indication of national development and budgetary priorities for the medium term.
- A budget circular is sent to spending agencies outlining the basis on which they should prepare their medium-term budget requests. This circular indicates the availability of budget resources, usually in the form of provisional agency or program expenditure ceilings, and the aggregate cost assumptions to be used, including changes in inflation and public sector pay.
- The budget requests of spending agencies reflect strategic objectives, the cost of current and new activities, expected cost recovery, and other relevant factors.
- Final expenditure ceilings are reflected in the annual budget submitted to the legislature for consideration.
- Spending agency budgets are finalized, and sector strategies are revised to reflect budget realities.
- Spending agency budgets and sector strategies are published.

MTPF

- Sector strategies discuss program outputs, outcomes, and performance.
- Agency output, outcome, and performance indicators are used to establish budget targets.
- Spending agencies report on results relative to targets. Comprehensive spending reviews are conducted periodically.

A significant amount of effort and substantial capacity development are generally required to achieve these good practices for an MTEF. To develop good forecasts, a well-functioning fiscal analysis unit (FAU) within the MOF should serve as the locus of analyses and reports on policy issues, tax collection and administration, and MOF budget development. Many developing countries do not have an FAU or it may lack sufficient capacity. Implementing good practices may require organizational changes, capacity development, and above all else, political commitment to making the changes (see section VII). In addition to implementing reforms at the MOF, support also needs to be given to MDAs to implement new reforms, including the development of strategic plans and the skills to develop realistic budgets that allocate funds in accordance with the strategic priorities of the government and fit within available funding resources. A useful corollary to such changes is the establishment of an independent fiscal analysis function for legislative bodies, which aids in effective decision-making and the formation of consensus for passage of the budget.

²¹ *Beyond the Annual Budget: Global Experience with Medium Term Expenditure Framework*, The World Bank Group: 2013, <<http://www.imf.org/external/np/seminars/eng/2013/fiscalpolicy/pdf/brumby.pdf>>.

III. BUDGET EXECUTION

This section defines the purpose and objectives of the budget execution process, roles and responsibilities of government entities in budget execution, common weaknesses, and leading practices. **Budget execution** is the step where goods, services, and infrastructure are procured to achieving the programmatic objectives outlined in strategic planning documents and the annual budget. In budget execution, budget plans and strategies are carried out and government policies are implemented.

In the PFM cycle, budget execution follows budget preparation and begins when the legislative body approves the annual budget establishing each MDA's budget for the year. Budget execution includes authorization and apportionment, commitment of funds, acquisition or procurement and verification, and payments. Figure 10 demonstrates how reporting occurs throughout budget execution and internal and external audit processes encompass the process.

Top Three Reference Materials on Budget Execution

1. *Commitment Controls*, IMF Technical Notes and Manuals: 2009
2. Williams, Mike. *Government Cash Management: Its Interaction with Other Financial Policies*. IMF Technical Notes and Manuals: 2010
3. *Guidelines for Public Expenditure Management*, International Monetary Fund: 2012

Figure 10: Critical Dimensions of Performance of an Open and Orderly PFM System



III.1 Budget Authorization and Apportionment

Once an annual budget is approved by the legislature, the MOF will authorize MDAs to begin executing their budgets. Rather than providing MDAs with 100% of their budget at the beginning of the budget year, the MOF typically apportions the funds into monthly or quarterly allocations. These budget allocations break down an annual appropriation into smaller amounts to help control expenditures and keep an MDA from over-spending by reducing opportunities to spend their annual appropriation in the first quarter of the year.

The MOF may divide a MDA's annual appropriation into 12 equal monthly allocations or four equal quarterly allocations. Alternatively, in some countries, the MOF requires budget authorities to develop a monthly or quarterly spending plan that identifies expected cash needs for the year. This spending plan serves as the basis for the monthly or quarterly allocations of cash by the MOF which reflect variations in spending patterns throughout the year. The use of spending plans and monthly or quarterly allocations also facilitates the MOF's cash management efforts. The MOF can compare projected revenue plans against consolidated monthly or quarterly spending plans and evaluate any disparities to determine short-term borrowing needs. The spending plans also allow budget officers within the MOF and MDA to monitor spending patterns and identify any over- or under-spending. In many countries, unspent funds from one year cannot be carried forward to the next fiscal year.

III.2 Acquisition & Verification

After an MDA begins receiving its budget allocations, it can begin spending its funds for program purposes outlined in its strategic planning documents and budget plan.

Public acquisition or procurement refers to MDA use of public funds to purchase goods and services during budget execution. The quality of procurement has a major effect on the efficiency and effectiveness of public entities. The World Bank estimates that approximately 30%–50% of a country’s total expenditures in the economy flow through public procurement systems. A good procurement process provides “value for money.” Value for money means that policy goals (effectiveness) can be achieved at the minimum practicable cost, including staff costs. To achieve value for money, public procurement and expenditure systems should be based on open competition, transparency, and accountability while minimizing fraud, waste, and corruption.

III.2.1 PROCUREMENT SYSTEMS

There are two types of approaches to procurement -- centralized and decentralized. In a **centralized procurement system**, one entity is responsible for obtaining goods and services for all central government MDAs and, in some cases, sub-national level MDAs as well. The centralized procurement unit may be an independent body or be based in the MOF or another ministry such as Public Administration or Government Services. Under a centralized procurement system, MDAs may still have autonomy to purchase some small items through direct shopping under a threshold determined by law. In a **decentralized procurement system**, MDAs procure their own goods and services.

Example: Procurement in Zambia

Until recently, all public procurements conducted in Zambia were made through the Zambia Public Procurement Authority (ZPPA), a central procurement unit. Although this system allowed for the achievement of efficiencies, budget authorities noted that approval times for procurements were often lengthy. In 2012, amendments were made to the Zambia Public Procurement Act which provided MDAs the authority to make their own procurements and mandated ZPPA to be an oversight body. Under the new arrangements, ZPPA’s responsibilities include setting regulations, monitoring compliance of regulations, and providing trainings to MDA procurement staff in leading procurement practices.

Figure 11 summarizes the pros and cons of centralized and decentralized procurement. Centralized systems allow for uniformity in procurement processes across the government and bulk procurement at reduced cost due to economies of scale. Decentralized systems are more flexible and able to respond to procurement demands faster.

In either case, it is important for a government to maintain appropriate national level procurement regulations, including a public procurement law, and for budget authorities to maintain their own policies and procedures that incorporate national legislation and provide more detailed guidance on staff roles and responsibilities in procurement. A common approach is to have a central authority set and monitor procurement regulations while each MDA has its own in-house procurement unit handling most procurements. National regulations may dictate that procurements over a certain monetary value require approval by the MDA and someone from the centralized procurement authority. Regardless of arrangements, it is important for a government to maintain appropriate national level procurement regulations, including a public procurement law, and for budget authorities to maintain their own policies and procedures that incorporate national legislation but provide more detailed guidance to staff on their roles and responsibilities in the procurement process.

Figure 11: Procurement Approaches

	Decentralized	Centralized
Pros	<ul style="list-style-type: none"> • Local procurement as and when required • No heavy initial investment • Orders placed quickly 	<ul style="list-style-type: none"> • Bulk procurement • Reduces transport cost • No duplication of efforts • Uniformity of procurement policies • Minimizes investment on inventory
Cons	<ul style="list-style-type: none"> • No economy of scale • Lack of specialized knowledge • Insufficient/excessive purchases • Absence of effective central control 	<ul style="list-style-type: none"> • High initial investment • Delay in receipt of goods by departments • More advance planning required • Entities may be located in different regions

Regardless of the institutional arrangements, major procurements generally follow a six-step process:

1. Requisition request
2. Bid solicitation
3. Bid evaluation
4. Contract negotiation and signature
5. Contract management
6. Verification

III.2.2 REQUISITION REQUEST

The procurement process begins with a requisition request. A user department completes a requisition form and submits it to the procurement unit. The requisition form should state the specifications of the goods or services and the quantity required. The quality of the request will affect the quality of the bids received. Good practice dictates that a requisition request should be signed off by the head of the department or agency when it is above a certain monetary value.

III.2.3 BID SOLICITATION

Upon receipt of the requisition request, the procurement unit will determine the type of procurement method to use based on regulatory requirements and the perceived best value for money. Typically, procurement legislation establishes certain thresholds above which particular procurement

approaches should be used. Rules may differ based on the type and monetary value of the procurement. For larger bids (especially for vehicles and construction), there may be a requirement to use open competition. Under open competition, bids are solicited through an open tender and advertised in websites and newspapers. A country may have different rules for domestic and international procurements. Common timeframes are 45 days for international competitive bidding and 15–30 days for national procurement. For smaller procurements, the law may allow requests for direct quotations from a minimum number of companies—typically at least three. For the smallest procurements—for example, coffee or office supplies—MDAs may be permitted to just shop and pay through petty cash or an imprest fund. Figure 12 summarizes common types of bid solicitations.

Figure 12: Types of Bid Solicitations

Bid Type	Description
International Competitive Bidding (ICB)	The most competitive method and entails open advertising both internationally and domestically. All interested firms are invited to submit proposals.
Limited International Bidding (LIB)	Used when a limited number of suppliers are available to deliver highly specialized goods. These solicitations are made by inviting competitive bids from a limited number of providers, often international firms with the required qualifications.
National Competitive Bidding (NCB)	Open to national as well as international suppliers, although only national advertising is required. This should be used when it is not expected that international firms will be interested because of 1) small contract values, 2) work spread out geographically or over time, 3) labor intensive, and/or d) goods or services are available locally at competitive prices.
Shopping	Shopping may be used for small purchases that can be obtained locally by having at least three suppliers submit quotes for comparison. This approach should be used for goods that are readily available off the shelf or standard specification commodities.
Direct Contracting	Direct contracting should only be used in exceptional circumstances, such as standardization of IT equipment, responses to natural disasters, or in cases where there is only one contractor that can carry out the work or provide certain goods.

Specific requirements and the deadline for bid submissions should be made publicly available and clarifying information requested by a potential bidder should be made known to all potential bidders. For competitive bidding, physical bid documents should be received by an individual who is not part of the bid selection process, who logs the bid receipt in a register. Once the bids are logged in the register, they should immediately be secured in a locked container, preferably in the presence of the bidders. Electronic proposals should be submitted to a specific e-mail account established for this purpose and a similar approach taken for logging receipts and to secure bids from unauthorized access. Proposals should not be viewed by the procurement office or bid selection evaluation team (Tender Committee) members prior to the official tender opening, and should be kept confidential until that time.

III.2.3 BID EVALUATION

For ICB, LIB, and NCB bids, evaluation and selection of a successful bidder should be done by a Tender Committee. Selection of Tender Committee Members is usually done by the head of an MDA or a central procurement agency. There should be clearly defined rules about the length of assignment and the number of terms allowed for tender committee members. The composition of the Tender Committee may vary by type of procurement to ensure that the Committee has the necessary technical expertise. The Tender Committee will evaluate bids based on the specifications provided by the requester and value for money principles, including quantity, quality, and cost. The Tender Committee should also take into account past performance of the bidder based on records maintained by the MDA or a centralized procurement database. A record should be maintained on the evaluation process and the scores or other rating system used to evaluate each bidder and the evaluation should be directly tied to the requirements, and any rating criteria, specified in the request for quotes/proposals/bids.

Bidders should be notified as to whether they were successful or not. Unsuccessful vendors should have the right to appeal. In the event of an appeal, the Tender Committee will review its bid evaluation process to confirm or revise its award decision. The outcome of the review process will be documented and sent to bidders in a written communication. In the event that the Tender Committee affirms its decision, the complainant will typically have the option for secondary appeal to a national level body such as the central procurement agency. Common evaluation methods used by Tender Committees to evaluate proposals for goods and services are covered in Figure 13.

Figure 13: Types of Bid Evaluation Methods for Goods and Services

Bid Evaluation Method	Description
Goods	
Lowest Evaluated Bid	Bids are first evaluated based on a pass/fail basis to determine if they meet minimum criteria. The winner is selected based on lowest cost. From the pass pool.
Scoring System	Under this system, the procuring entity establishes a scoring system based on the various selection criteria including cost, past performance of the provider, and technical specifications.
Sole Source Selection	In some instances, there may be a justification for a sole source selection because only one vendor is able to provide the goods or services that meet the exact specifications required. An example may be in the IT sector where a good or service is required that is compatible with the overall IT environment.
Services/Works	
Quality- and Cost-Based Selection	This method is similar to the lowest evaluated cost method for goods. It uses a “two-envelope system” in which the financial proposal and technical proposal are separated. The technical proposals are considered independently without financial considerations. The cost proposal is only considered for the highest technically rated bids, based on a weighting procedure.

Bid Evaluation Method	Description
Quality-Based Selection	This method is similar to quality- and cost based selection with a higher weight given to the technical proposal than the financial proposal. (for example, 95% for the technical proposal and 5% for the financial proposal).
Selection Under a Fixed Budget	The budget is advertised in the Request for Expressions of Interest and the same system is used for the quality- and cost-based selection procedures.
Least Cost Selection	This approach entails a two envelope system as in the quality and cost based selection. Once the technical proposals have been evaluated and ranked, the financial proposals of the firms that meet the minimum qualifying marks will be opened. The lowest priced proposal will be accepted regardless of the technical ranking.
Selection Based on Consultants' Qualifications	A pre-specified number of consulting firms are shortlisted and ranked based on specific criteria and then the highest ranked firm (only the single highest rated firm) is invited to submit a combined financial/technical proposal.
Single-Source (or Sole-Source) Selection	This method should only be used under exceptional circumstances, e.g., to follow-up on a previous competitively selected or if there is only one provider of essential goods or exceptional capacity for service provision. This approach is often over-used and increases the risk of politicized selection, waste, fraud, and abuse.

III.2.4 CONTRACT NEGOTIATION AND SIGNATURE

The procurement unit will negotiate the terms of the contract with the first choice bidder. Key issues should have been included in the request for proposals, including specifications and delivery date, but there may be some small items to negotiate including requests for changes in the specifications or schedule. An MDA will typically have a standard contract that stipulates payment terms (time for the vendor to receive payment after submission of proper invoice) and other standard clauses. The contract should also include milestones, payment schedule, and reporting requirements. Typically, there will be dual signatures on a contract or purchase order, including the head of procurement and the director of finance. A clearly defined dispute mechanism for dispute resolution should be stated in both the contract and the MDA's procedures. It should designate the process of appeals in the event that an agreement cannot be reached between the MDA and contractor.

III.2.5 CONTRACT MANAGEMENT

For larger or longer contracts (such as building construction), the MDA will need to devote significant resources to contract management. These tasks include oversight of the vendor, periodic review of work performed, and monitoring contract performance to ensure that deadlines and quality specifications defined in the contract are being met.

There should be written rules, regulations, policies, and procedures governing these processes and they should be quoted or referenced in the contracts. All reports and other documents associated with all phases of contract management and verification should be signed by both the individuals performing the action and of the official with ultimate responsibility.

III.2.6 VERIFICATION

After the goods and services have been received, procurement staff must verify receipt or completion according to the contract specifications. Received goods should be inspected immediately for any damage. If a more in-depth inspection is needed, it should happen within 1-2 days of delivery. Some goods or services may require testing to determine that they perform at a satisfactory level; examples include clinical or research products, software, and capital equipment. During the inspection, the supplier's packing list or submission memo (itemizing the contents) should be compared to the original purchase order and invoice to determine if there are any discrepancies. Good practice is that the items are verified by representatives from both the user department and procurement unit and that both parties sign off on the appropriate proof of delivery documents. All relevant documents (such as the purchase order, packing list, invoice, and proof of delivery) should be kept in the procurement file. These documents should be subject to performance audits by an internal auditor.

Example: Verification in District Health Offices

District Health Offices in Country X sign a handover form when goods are received to verify receipt of goods. When acknowledging receipt, only a basic inspection for quantity and blatant damage occurs. Goods that are visibly damaged are returned immediately. Full inspection only occurs at a later date during a formal inspection process. While contracts with third party providers stipulate that damaged expired or incomplete shipments may be returned to the supplier, it is difficult to determine whether damage occurred pre or post-acceptance.

The government or MDA should have policies and procedures to deal with incorrect, inadequate, partial deliveries, or over fulfillment of orders. If deliveries are incorrect (wrong products) or inadequate the item, is out of date, damaged, or below expected

quality), the supplier should be notified immediately and required to provide the goods/services stated in the contract. Payment should be withheld until receipt of the proper quantity and quality of goods and services. As an additional safeguard against inadequate vendor performance, it is a common practice to withhold all or part of the total payment until final acceptance and verification. When a partial delivery is received, the supplier should be notified immediately and arrangements negotiated to pay for only the items received or, preferably, the withholding of any payment until receipt of the full order. For over-fulfillments, the supplier should be notified immediately and arrangements made to either return the items or credit the buyer on the current or a future payment. Adequate verification requires that the individuals who perform the function and responsible management take personal responsibility for the verification by providing signatures.

III.2.7 PROJECT CLOSE-OUT

After all goods or services under the contract have been received and payment made, the procurement unit should close out a contract. Close-out involves making sure that the procurement file is up-to-date and comprehensive, including 1) procurement plans and/or a requisition request, 2) bid documents, 3) bid opening records/minutes, 4) notice of bidding/advertisement, 5) bid evaluation reports, 6) negotiation communications, 7) contract,

8) notification of successful and unsuccessful bidders, 9) report on the supervision/inspection of works, 10) request for quotations, and 11) payments made against the contract.

III.2.8 COMMON CHALLENGES

Because of the large amount of public funds used for government procurements, this is an area where particular vigilance must be maintained to avoid waste and corruption. Problems in procurement systems are often due to poorly designed systems or poorly performing systems. Procurement systems should be designed to obtain, multiple, competitive bids and contain internal controls. Procedures and controls must be enforced to reduce the risk of corruption and collusion between government employees and vendors (e.g., kickback schemes), otherwise efficiency and effectiveness will be jeopardized. Corruption cannot be completely eliminated, but represents the largest obstacle to a strong procurement system when there is a lack of political will to rectify the situation. Private and public sector perpetrators who benefit from flawed systems have a vested interest in maintaining the status quo. Some other common challenges facing public procurement systems include

- Lack of an effective institutional framework governing procurement at the central level and related policies and procedures guiding procurement at the MDA level;
- Weak or inconsistent enforcement of the prevailing rules;
- Inadequate or infrequent audits of the procurement system stemming from a lack of funds or staff to perform periodic audits by the regulatory agency or the supreme audit institution;
- Procurement staff's lack of technical knowledge of the key elements of a well-functioning, modern legal and institutional public procurement framework. This is made worse by the fact that procurement staff, particularly in decentralized systems, often have insufficient training; and
- Mismanagement of contracts (poor oversight, deliverable delays, delays in payment to vendors), often the result of fraudulent and corrupt practices, absence of policies and procedures lack of enforcement of policies and procedures, and lack of technical capacity.

Many reforms can be introduced to reform an existing procurement system. Transparency and separation of duties are key factors. Public procurement laws and regulations should be communicated to MDA procurement staff and well understood. Different individuals should be responsible for determining the need for goods/services and defining the specifications, soliciting bids, evaluating and selecting bids, signing purchase orders and contracts, and verifying receipt. Procurement files should be comprehensive, organized, and secure to allow auditors to perform finance or performance audits. The central procurement unit or procurement regulatory agency should conduct performance audits on MDAs to ensure they are interpreting regulations correctly and maintain a list of debarred vendors.

Example: USAID Support for an E-Procurement System in Albania

Procurement reform efforts in Albania were initiated in 2006 as part of a joint pledge between the Albanian government and the United States to reduce corruption. Under a Threshold Country Plan an e-procurement system was introduced. Support included upgrading the Public Procurement Agency's website to enable uploading of tender documents. In addition, the Agency was empowered to act as the supervisory and training authority for all central and municipal government procurements. Finally, training was provided to 1,000 procurement officers and private businesses on the new e-procurement system. As a result, 73 electronic tender awards were made in the first nine months of 2008 totaling \$29 million in value with an average of more than six bidders per tender.

Another option for procurement reform is an e-procurement system, that allows government procurements to be conducted via the internet or similar networking system. MDAs can issue requests for proposals/quotations on their own website or a centralized government website. Potential vendors can download procurement notices and tender documents; submit questions and

proposals, complaints and appeals through the website. E-procurement systems can improve government performance by allowing requisitions to be routed to the appropriate individuals for approval. Other advantages of E-procurement systems include time and cost savings for applicants and agencies and improved transparency. Because procurement requests posted on the web can be accessed anywhere, the number of potential bidders may increase, including regional and international bidders. E-procurement systems may not be appropriate for all countries, especially in developing countries where the government's IT-infrastructure is weak or the majority of potential bidders do not have regular access to the internet or computers.

III.3 Payment Procedures

After verification of receipt, an invoice can be processed for payment. The institutional structure and operational arrangements for payment procedures vary across countries, but can be classified as either centralized or decentralized. With centralized payments, MDAs initiate purchase orders and conduct verification in-house, but payment is made by the MOF or Treasury. In a decentralized payment system, MDAs pay vendors themselves.

Under a centralized system, the MDA's finance department submits a payment request form attaching any required supporting documentation (invoice, proof of delivery, purchase order or packing list) to the payments department in the MOF. Within the MOF, the payment request undergoes the following steps: confirmation that budget funds are available input to the FMIS (if applicable), approval, preparation of payment instrument (check or electronic fund transfer), approval of the payment instrument, and issuance of payment. Payment is generally made directly to the vendor, although in some countries payment is released to the MDA who in turn pays the vendor. Best practice is for payment to be made by electronic transfer to reduce risk, provide an audit trail, and eliminate the need for the vendor or MDA, to pick up the check at the MOF. This reflects the importance in all financial practices to minimize the necessity for personal contacts to remove or reduce the potential for collusion. An added benefit of making payments through the MOF is its ability to require vendors to have a tax identification number prior to payment, thus improving revenue collection.

Under a decentralized payment system, a user department will prepare the payment request and documentation that is transmitted to the MDA finance department. If the documentation is correct, it is approved and entered in the accounting system. The bill is then paid by cash, check, or electronic fund transfer from accounts assigned to the MDA.

III.4 Asset Management and Inventory

After goods are procured and their receipt is verified, the MDA's must record non-expendable property in a fixed asset register (FAR). A FAR lists assets owned by an MDA, usually including items that can be capitalized, such as minor capital equipment and consumer durables (e.g., computers, vehicles, office furniture, and laboratory equipment). These items should be labeled with a permanent ID tag and that ID number is recorded in the FAR. A FAR is usually maintained by an MDA's asset management or finance department. Entries in the FAR often require approval by two members of the finance department, an accountant and a supervisor. In some countries, the FAR is integrated into the FMIS through an asset management module, which affords greater centralized control.

A FAR can help prevent theft and/or the misappropriation of assets. It also can be used to keep track of the value of assets and allows for computation of depreciation. Depreciation is an important component of the annual financial statements using accrual accounting (*see Section IV on Public Sector Accounting*). If an asset is sold at a price higher than the original price minus depreciation, a credit may be added to the balance sheet. If the asset is sold at a price lower than the original price minus depreciation costs, a debit may be added to the balance sheet. Annual audits of the FAR help ensure items currently owned are cataloged, correctly valued, can be located, and are operable.

Some government MDAs manage active inventories of goods, such as pharmaceuticals, and therefore may require an automated asset and inventory management system. Such systems help track shipment arrivals, warehouse placement, units sold or distributed, current stock levels, and provide information on when to replenish or replace dated inventory.

A key challenge in asset management is the volume of data to be organized. It is often best to develop FAR in the central ministries (e.g. MOF) and subsequently implement in sub-national levels of the government. Another key challenge involves tracking assets that move or are transported between locations. The greatest challenge is the fact that each fixed asset has its own depreciation schedule and life cycle. Cataloging and tracking this information will help understand an MDA's financial position and future obligations for replacing assets.

III.5 Payroll

The payment of salaries and wages to public employees is often the largest expenditure category for any government. Due to the political nature of public sector wages (and wage negotiations), it is usually considered a protected expenditure. Due to its volume and complexity, effective government payroll management is needed in order to mitigate misappropriation and corruption.

Government payroll is based on a personnel database that lists all staff that are to be paid each month. People in the database should be verifiable against the approved establishment list—the approved list of budgeted positions. In many countries, these databases are not directly linked and are often not updated to systematically reflect new hires, terminations, retirements and transfers. A consequence of such fragmentation of the database is the so-called “ghost employees” who have been terminated, left the institution, or are perpetually absent, yet continue to receive payment through the payroll system. Another potential consequence is multiple entries of a single civil servant, allowing that person multiple payments.

A driver of fragmentation in the payroll system is poor coordination between the entity responsible for paying salaries based on the personnel database (MOF, Ministry of Labor, Ministry of Public Administration, etc.) and individual MDAs who make personnel decisions (i.e., staff hiring and termination). When MDAs do not regularly update their staff lists/databases, then the MOF can continue to make erroneous payments.

A comprehensive government employee census is needed to increase reliability of the payroll system. In some countries, MDAs hold an annual staff census, and only employees who are physically present continue to receive paychecks. Some countries require staff to physically present themselves each pay period to receive payment, while others have introduced biometric controls such as fingerprint verification before payment is made. Other payroll challenges include:

- **Time and Absence Control:** This area includes the procedures for submitting and certifying timesheets and authorizing overtime. Controls should be in place to discourage absenteeism and falsification of timesheets. Requiring timesheets and the working of overtime to be authorized by a senior officer can mitigate those risks. Biometric access controls can also be used to record employee time and attendance.
- **Payroll Preparation:** Controls should be in place to mitigate payroll errors, such as requiring that the payroll is checked by two senior officers and that segregation of duties are in place, so that final approval of payment is provided by a person independent of those who prepare the payroll.
- **Payment Controls:** Controls should be in place to ensure employees are properly identified before payment, such as requiring signatures (or identification) prior to receiving paychecks.

In some countries, payroll is integrated into the FMIS through a payroll module. This allows for better tracking of salary and allowance expenditures. As funds are released through the FMIS, budget aggregates are updated and reflect new balances. The use of FMIS for payroll allows for electronic fund transfer rather than cash payment. This practice is recommended because it provides a somewhat less expensive and more verifiable system.

Internal controls and audits are the cornerstone of any payroll management system. Authority to change records and the payroll should be restricted and should provide an audit trail. Periodic payroll audits can identify ghost workers and control weaknesses as well as, fill data gaps.

III.6 Commitment of Funds

The precise definition of a ‘commitment’ varies according to country and the accounting standards being used. Generally, a commitment arises when a purchase order is made or a contract is signed. This implies that goods or services will be delivered and that there will be a bill later on. There are two main types of commitments:²²

²² Dimitar Radev and Pokar Khemani, *Commitment Controls*, IMF Technical Notes and Manuals: 2009, <<http://www.imf.org/external/pubs/ft/tnm/2009/tnm0904.pdf>>.

Specific commitments are those that require a single payment or a series of payments over a determinate period of time. These include contracts for goods and services and occur when a formal action is taken by a MDA such as placing an order for supply of goods and services, issuing a local purchase order, or awarding a contract to a supplier.

Continuing commitments are those that require a series of payments or settlement actions over an indeterminate period of time. This does not necessarily involve a specific contract. This kind of commitment includes wages, utilities, scholarships, entitlement payments, and other similar arrangements.

When executing an annual budget, a typical MDA will incur both specific and continuing commitments. For example, a Ministry of Health may place an order for essential medicines for which it will pay a pharmaceutical vendor a one-time payment (specific commitment). These drugs will then be distributed by a district health worker who is paid an annual salary (continuing commitment).

In general, properly managed specific commitments are similar to obligations under the USAID accounting system. That is, funds are obligated, or set aside, when contracts are signed. In practice, often commitments in developing countries are set aside in their entirety once the contract or agreement has been executed. This contrasts with USAID obligations that are made for a set time period of funding. In full commitment systems the partner country's commitment would thus be equivalent to USAID's obligations and mortgage for a contract.

Different categories of commitments can have different cash requirements for payments. For example, salaries, wages, and allowances are commitments MDAs will generally have to honor based on a contractual agreement between the employer and employee. At any point in time, MOF and MDA senior staff should know what these costs will be per month/annually into the foreseeable future. Capital projects are probably the most difficult to forecast in terms of both commitments and the associated payments. Most projects are the result of contracts and payment details are largely known when the contract is signed. These commitments can cover a long period of time (probably more than one year) and expenditure flows can be "lumpy." Because delays can occur in construction and delivery, updated forecasts on the progress of work and requirement of funds are regularly needed. Other commitment categories include: programmatic supply costs; financing costs (debt or loan costs); and other recurrent expenditures (telephone services, office supplies).²³

Commitment of resources is a critical stage in the budget process and controlling those commitments is essential for controlling expenditures. To avoid the accumulation of arrears, governments must enact *commitment controls*. The International Monetary Fund (IMF) notes, "The key objective of commitment control[s] is to manage the initial incurrence of obligations, rather than subsequent cash payments, in order to enforce expenditure ceilings and avoid expenditure arrears."²⁴

Developing country governments often lack an effective system for tracking committed funds. The inability to set aside or "ring fence" funds for certain obligations from the general pool of funds can result in the same funds being committed for multiple purposes. Key commitment controls include:

- A budget based on realistic revenue and expenditure projections;

²³ Dimitar Radev and Pokar Khemani, *Commitment Controls*, < <http://www.imf.org/external/pubs/ft/tnm/2009/tnm0904.pdf>>.

²⁴ Ibid.

- Requirements for the MDA and/or the MOF to verify by signature that funds are available and budgeted for expenditure;
- Designation of specific senior officers (e.g., heads of departments) who can authorize the purchase of goods and services (i.e., initiate a purchase order), that should be based on line items in the submitted/approved budget; and
- A computerized FMIS with a well-designed commitment control system as well as requirements that accurate and timely recording of all commitments and expenditures be made by MDAs with punitive measures for noncompliance (*see Sub-Section on Financial Management Information Systems in Section IV Public Sector Accounting*).

Institutional design and operational arrangements for commitment controls vary by country to, and, as with payment procedures, can broadly be classified as either centralized or decentralized. A centralized system requires MDAs to make all commitments/purchase orders through the MOF/Treasury. MOF/Treasury then verifies that the funds and budget are available to cover the commitment, as well as verifying receipt of the goods or services before payment is provided. Decentralized commitment controls require MDAs to manage these responsibilities (ideally with senior officers signing off on verifications and payments). Centralized systems allow for greater centralized cost control and expenditure monitoring, and may result in longer approval times. Decentralized systems tend to be more flexible and quicker to respond to the programmatic needs of MDAs, and may result in overspending if effective commitment controls are not in place.

III.7 Revenues

The funds governments use to provide goods and services or support the general public administration are generated from a variety of revenue instruments: taxes, fees, fines, penalties, social contributions, income from investments, and sale of property, grants, or other. The ease of collecting each type of revenue varies. Following a revenue system should:

- Generate sufficient revenue for the government;
- Be simple and easily understood by taxpayers;
- Impose minimal compliance costs for payers and minimal administrative costs to the government;
- Limit distortions to the economy;
- Be stable, generating consistent and predictable levels of revenue for the government, with rules that provide sufficient certainty to payers; and
- Be equitable, distributing burdens fairly amongst payers.

Often, it is impossible to achieve all these objectives, but domestic revenue mobilization systems should be designed to minimize any negative consequences insofar as this is possible.

III.7.1 REVENUE POLICY CONSIDERATIONS DURING THE BUDGET PROCESS

Policy plays an important role as revenue policy and revenue collection impacts the level of expenditure possible versus the needed borrowing. The MOF, the tax administration, or, ideally, both need expertise to:

- Forecast revenues to develop the fiscal outlook for budget planning;
- Analyze changes in legislation that enhance the fiscal outlook for budget planning; and
- Monitor and report during budget execution on whether revenues and expenditures are aligned to the budget.

Additionally, revenue/budget experts will also:

- Support the MOF or the head of tax administration with daily feedback;
- Undertake research on fiscal issues;
- Propose changes to fiscal laws, to the MOF or the head of the tax administration; and
- Communicate with similar experts in other government institutions, academia, the private sector, or civil society organizations to enhance effectiveness throughout the public finance cycle.

Similar support should be provided to the legislature and any other institution that has a central role in financial planning or operations. In several developing countries, government institutions retain their historical focus on operations. There, a tax administration may only account for the money received by the government, without analyzing policy.

Most modern MOF include a separate policy division, with units responsible for macro-economic analysis, budget, revenue, and deb. These are supported by a unit with legal expertise. Separating the policy division from operations ensures that the MOF receives day-to-day support that allows him/ her to act as the country's chief financial officer. The unit should be closely aligned for effective collaboration because many policy issues are interrelated.

A modern tax administration often has a unit responsible for tax policy typically placed under a division responsible for all policy, including operational policy. Separating (as well as centralizing) operational policy from operations is, in fact, good management. Placing the tax policy unit closer to the operational policy division, again, ensures the needed level of cooperation and eases IT and legal support. There are, however, some differences in effectiveness. While the revenue policy staff in the Ministry may collaborate more easily with macro-economists in the same division, the revenue policy staff in the tax administration may have more access to revenue data.

Wherever revenue policy staff is placed, a number of staffing and organizational considerations are similar. An appointee/permanent staff mixture is preferred. Appointees will tend to carry the government's message more consistently, while permanent staff will ensure continuity of expertise. Specialization is needed. Revenue instruments differ and intimate familiarity with each helps analysis. Redundancy (several staff with similar

specializations) also ensures continuity. Education is preferred (e.g., degrees in economics, accounting, or law), but experience is a must, as the specific knowledge required is rarely taught in academia.

Revenue policy units should develop and maintain databases of economic and fiscal variables. They also need tools that allow them to analyze those variables. The tools can be simple or complex. Because no one tool can estimate every possible economic or legislative scenario, experience is essential.

Typical Monthly Revenue Monitoring

In the fifth month of the fiscal year, revenue policy staff of the tax administration obtains reports on revenues collected through the previous month from the tax administration's IT system. They analyze the reports and note that income tax revenues collected during the first four months amount to 60% of the projected total for the year that was included in the budget. Historical data, however, suggests that the percentage collected in previous years was 70% for the same period. Most of the income tax is collected during the first four months as this is when the law requires most taxpayers to file and pay.

Revenue policy staff analyze the reason for the difference. Typical options include:

- 1) There was a dip in the economy in the last months of the previous year that was not properly accounted for during budget preparation and this trend will likely continue;
- 2) A couple of large exporters were recently impacted by the lower demand for their product abroad and reduced their advance tax payments;
- 3) A couple of large exporters reported delays in contracts, and their situation is likely to be reversed;
- 4) There was an error in the original revenue estimate for the budget cycle;
- 5) There was a delay in transfers of revenue from the banks; and
- 6) Other reasons.

After discussion with macroeconomists in the MOF and staff of the National Statistics Institute, revenue policy staff understand that there was a dip in the economy in the last months of the previous year and that this trend will likely continue. They revise the estimates for the expected annual revenues, draft appropriate memoranda, and notify the cash management group in the MOF and the Minister of Finance.

Two revenue instruments deserve special attention — taxes and fees which are described further below.

III.7.2 TAXES

Taxes are the compulsory, unrequited payments to the general government sector — a definition adopted by the OECD,²⁵ the IMF, and the World Bank. The fact that taxes are imposed on taxpayers and not visibly proportional to the benefits or services that taxpayers receive from government has far reaching implications. For example, when benefits are not visible, compliance may be difficult to attain. When taxes are compulsory, "free market"

²⁵ "Revenue Statistics 1965–2011," The OECD Classification of Taxes and Interpretative Guide, OECD: 2012, p. 322.

economic principles do not apply and it is difficult to relate the size of benefits to the amount expended. Nevertheless, tax revenues are the primary source of revenue for the central governments of most countries.²⁶

Taxes and Economic Efficiency

In 1974 Chile decided that an efficient tariff system was one that imposed the same tariff rate on all goods. Chile's policymakers decided that less interference with the workings of the economy is better, chose a neutral customs tariff system, and gradually changed all tariff rates to 5%. Bolivia implemented similar policies in 1985. Egypt has been following these examples (albeit slowly) since 1991. Jordan has chosen the opposite route, imposing high tariffs on final assembly manufacturing of up to 30% and low tariffs on intermediate imports of, in most cases, zero. Jordan's policymakers believe that economic growth can be promoted by protecting and promoting final assembly manufacturing.

Modern taxes are similar and fit into a few categories — i.e., taxes on income and capital gains, payroll, property, goods and services, and international trade. This allows practitioners to discuss 'modern' tax systems that rely on 'core' taxes, such as income

taxes, value added tax (VAT) or general sales tax, excise taxes, property taxes, property transfer taxes, and customs duties.

III.7.3 Fees

A government may charge a fee for a specific service from the person interested in obtaining the service. Unlike taxes, fees are not compulsory and there is a direct relationship between the benefit received and the payment. This implies that beneficiaries can be identified, that the service is identifiable, and that the payers and beneficiaries are the same. Fees may be charged by any level of government. Because the above conditions do not hold for many of the goods and services provided by the central government (e.g., national defense, the public administration), the central government relies on fees only occasionally (e.g., copyright fees). Sub-national governments and especially local governments rely more heavily on fees as they are "closer" to their constituents and therefore can more easily determine the demand and beneficiaries of services.

The government entity that provides a service should charge and collect the fees for that service. To the extent that a MDA collects fees, it may remit them to the treasury or retain them. In either case, the fee collections should, at a minimum, be reported so that the central government understands its overall financial position and the revenue can be

Examples: Setting Fee Levels

- A fee must be priced reasonably according to the benefit; a fee may be a de facto tax if it is involuntary or simply inelastic.^{27 28}
- A key principle adopted by the Australian government administration is "any charges should reflect the cost of providing the product or service."²⁹
- The European Union required member states to comply with a newly issued directive in 2006 that stated that any procedures to obtain a formal decision from the government "...shall be easily accessible and any charges which the applicant may incur from their application shall be reasonable and proportionate to the cost of authorization procedures..."³⁰

²⁶ *IMF Data Library*, International Monetary Fund, <<http://elibrary-data.imf.org>>.

²⁷ Richard M. Bird, "User Charges in Local Government Finance," World Bank: 2003, <<http://www1.worldbank.org/publicsector/decentralization/June2003Seminar/Bird2.pdf>>.

²⁸ A service or good has inelastic demand if the quantity demanded from this service or good responds little to changes in prices.

²⁹ *Australian Government Cost Recovery Guidelines*, Australia Department of Finance, No. 4: 2005, <www.finance.gov.au/publications/finance.../Cost_Recovery_Guidelines.rtf>.

³⁰ "Directive 2006/123/ec of the European Parliament and of the Council," Official Journal of the European Union: 2006, <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:376:0036:0068:en:pdf>>.

properly recorded and incorporated into the budget and financial systems. During budget planning and preparation, if the fees are retained by the collecting MDA, they should be properly forecasted and included in any budget requests. During budget execution, fee collections should be monitored to ensure that overall revenues are in line to satisfy the budget.

Specifically, the government (typically the MDA responsible for administering the fee), should be able to estimate the future demand for the service as well as the future level of the fee. , The level of the fee should be set to reflect the cost to the government of providing the service. With respect to the objectives of revenue policy (simplicity, adequacy, etc.), that also apply to fees, this costing principle is an additional objective for the appropriate setting of fees.

Often, a central government agency (e.g., the Ministry of Finance) will issue cost specific guidelines to individual MDAs to guide fee setting. These cost guidelines will dictate the level of fees, as well as requirements for information and documentation.

Table 2 provides an example from Qatar of a good practice system for determining fees based upon the costs of providing the services. While the details of such systems may vary, the principle that fees should be directly related to costs should remain paramount.

TABLE 2: Extract from Qatar's Fee Costing Guidelines

General pricing guidelines

- Fees should be set at a level that fully recovers the cost to the government of providing the good or service;
- If private markets for the same service exist, the need to continue to provide the good or service should be reviewed. If the government continues to provide the service, the government should not compete with the private markets and should set the fee at the higher of full cost recovery or market price;
- To allow for level adjustments, fees should be designed so that their level requires approval only by the relevant minister or budget entity head;
- The level of fee should only be varied if there are actual changes to the cost structure, or market conditions;
- Budget entities should establish documentation for the costing of fees and pricing policies along the guidelines provided here; and
- Budget entities should report variations to the structure and level of fees to the Ministry of Economy and Finance.

Pricing documentation:

- All entities that impose fees should document the procedures employed for setting the level of fees and should use these guidelines as a basis;
- This documentation should be reviewed and updated annually by entities; and
- Entities should publish the levels and structures of fees in the Official Gazette at least annually and whenever there are changes.

III.7.4 TAX ADMINISTRATION

The tax administration department is the division of the government tasked with collecting taxes. Many governments actually have more than one tax administration agency. It is preferable (with the exception of customs duties) that the collection of all core taxes be the responsibility of a single organization. This allows the agency to better manage compliance because it has an integrated perspective of all the accounts of a single taxpayer.³¹ Often, the tax administration department is a part of the MOF or a Ministry of Revenue, and sometimes it is an independent MDA.

Taxes are not generally collected by the agency responsible for providing the specific service, although some sub-national taxes (e.g. property taxes where these are for dedicated uses) may be so collected. There are many reasons for this, not the least of which is the fact that there is no "specific service," as well as the fact that the lack of a clear service, as discussed above, creates problems with compliance that must be addressed with specialized, complex administrative processes.

The responsibility of any tax administration agency is the same: to collect the right amount of tax from the right taxpayer at the right time (according to legislation) and to do so at minimal costs of compliance to the taxpayer and minimal costs of administration to the government. Historically, tax administrators were "tax collectors," enforcing compliance by expending efforts to ensure that each taxpayer paid the amount he or she was obliged to pay. Today, tax administrations recognize that, with limited resources, it is not possible to effectively enforce compliance for all taxpayers and focus on three key objectives: 1) enable and enhance voluntary compliance; 2) monitor compliance to discover those who do not comply voluntarily; and 3) enforce compliance for those who do not comply voluntarily. To do so, modern tax administrations typically perform the following functions:³²

- **Maintain a register of taxpayers** — the collection, recording, and maintenance of basic identifying taxpayer information permits the tax administration to understand its taxpayer base and to plan accordingly;
- **Provide services, support, and education to taxpayers** — the information, forms, publications, and tax education that the tax administration provides taxpayers to help them comply with their tax obligations, to demonstrate that they are considered valued customers of the tax administration, and to reduce the need for extensive enforcement, given limited resources;
- **Process tax declaration filings and tax payments** — support the two primary obligations of the taxpayer, with the dual purpose of collecting revenue and collecting information to monitor compliance;
- **Audit taxpayers** — the processes used by the tax administration to monitor compliance, by selecting filed tax returns to audit/verify income, expenses, and supporting information reported by the taxpayer and to make additional assessments that require collection action;

³¹ Customs, the agency responsible for collecting taxes on international trade, should likely remain separate, as, unlike the administration responsible for "domestic" taxes, Customs may also be concerned with national security and health. In addition, Customs' day-to-day activities differ, as it undertakes much more of a "real time" approach to monitoring compliance — auditing transactions as they happen, rather than after the fact as a tax administration does.

³² Terry Murdoch, Ronald McMorran, Anton Kamenov and Johan van der Walt, *Tax Administration Reform: A Primer*. USAID Bureau for Economic Growth, Education and Environment: 2012, <http://pdf.usaid.gov/pdf_docs/PNAEA058.pdf>.

- **Address taxpayer objections or participate in the formal process to address taxpayer appeals** — allow for a system of checks and balances to institute further trust in the tax system and enhance voluntary compliance;
- **Collect tax arrears (as opposed to current tax payments)** — collect taxes that are due, assessed, and not paid by the due date under the law, including use of enforcement measures, such as liens, levies, and seizure and sale of taxpayers’ property; and
- **Investigate fraud** — the purpose of this function is not so much to collect revenue, but rather to publicize cases of fraud and thus deter future non-compliance as well as institute further trust in the equity of the tax system.

Several functions provide significant support to enable the tax administration to perform its duties:

- **Information technology (IT)** supports all core functions above. IT eases the collection, processing, and maintenance of information during registration, filing, and payment for use during audit and collections; enables the management of risk during audits and collections; facilitates filing and payment by taxpayers, and facilitates the distribution of performance information throughout the tax administration;
- **Internal audit** ensures that selected regulations, operations, and administrative procedures and programs conform to specified standards and are being implemented efficiently and effectively, including the analysis and verification of accounts, financial transactions, and reports;
- **Integrity investigations** — investigations about the conduct, such as alleged or suspected corruption, of any member of the tax administration’s staff; and
- **Legal services** — services provided to technical and management personnel by a cadre of attorneys of the tax administration, including legal interpretation of tax laws and regulations, and representation of the tax administration in all judicial forums, including tax appeals.

Example: Guatemala’s BancaSat eTax Services

In August 2001, Guatemala initiated BancaSAT, an online tax filing and payment system supported by the World Bank and managed by the Guatemalan tax agency, Superintendencia de Administración Tributaria (SAT). In December 2002, BancaSAT accounted for 84% of the tax revenues of the country. The online system has significantly reduced SAT’s transaction costs and improved service delivery. The system is considered largely successful and highly regarded by users, in particular because of its simplicity.

Tax administrations face a complex operating environment. First, taxpayers are numerous and different. Large taxpayers, those responsible for a significant portion of the revenue, may have complex transactions, with solid accounting systems and records,

while small taxpayers may operate simpler businesses without proper books and records. Many tax administrations recognize the need to vary services and the general treatment of taxpayers. Second, monitoring compliance is a constant challenge given the complex taxpayer population, the increasingly globalized world, and the limited resources of tax administrations in many countries. Many tax administrations undertake risk-based approaches to compliance monitoring and enforcement. In all cases, tax administrations establish productive relationships with other institutions, such as the judiciary, private sector groups, international associations of accountants and attorneys, and others. Finally, tax administrations all over the world are faced with powerful opportunities and challenges to use modern information technology in their operations.

III.8 Treasury Operations and Cash Management

The smooth functioning of cash management is critical to the implementation of government programs as planned in the budget documentation. In order to make acquisitions and pay vendors, as well as pay wages to employees, a government must have money available to meet its obligations. Effective cash management entails having a strategy and associated processes in place for meeting a government's financial obligations. This means collecting money, making payments owed by the government and investing idle cash to earn revenue. In other words: having the right money in the right place at the right time to meet government obligations in the most cost effective way. Cash management is generally the responsibility of a cash management unit housed within the MOF or Treasury Department.

The primary objective of cash management is to maintain liquidity so that the government is always in a position to meet its obligations when due. This requires effective cash flow forecasting, or managing the timing of revenues (cash inflows) so as to be able to meet payments for expenditures (cash outflows). One of the key challenges faced by the cash management unit is designing, developing, and implementing collection systems to collect funds through various government streams. Key cash management objectives are discussed below:

- **Managing liquidity:** Government cash management deals with both collections and disbursement. It is the responsibility of the cash management unit to make sure that the government is liquid at any point in time. This means that it has to be able to make good on its commitments when payments are due.
- **Cash flow forecasting** is the most critical function of liquidity management. Governments, especially those in developing countries often have little capacity to produce regular cash flow projections. This can lead governments to incur significant, unnecessary borrowing costs.
- **Reducing waste and borrowing costs** are key functions of the cash management unit. This includes reducing waste by managing idle cash balances through the use of cash flow forecasting and investing excess cash in short-term investments or paying off debt and reducing borrowing costs to the government by using appropriate banking services and/or limiting the need for short-term borrowing.
- **Manage bank accounts:** Managing bank accounts is a major task for government cash management units. Governments that do not use a single treasury account system (discussed below) tend to have thousands of accounts throughout the banking system. Often these accounts hold significant cash balances and are outside the control structure of the treasury. Managing these accounts includes performing assurance functions on the bank documents, authorizing signers and ensuring account reconciliation to the general ledger.
- **Bank relationship management:** The cash management unit is also responsible for determining which commercial banks the government can do business with, as well as maintaining strong relationships with financial institutions to facilitate smooth collections and disbursement systems. It should have periodic meetings with the banks to get an update of markets, new services, as well as periodic reviews of bank pricing.
- **Short-term debt and investment management** are also responsibilities of the cash management unit. This includes investing the government's cash in the event of a surplus and/or managing debt vehicles (e.g., loans, bonds) in the event of a deficit. Debt can also be incurred to fund a capital project.

- **Implementing cash management systems:** There are several cash management systems (e.g. FMIS) that a government can employ depending on the financial sector's state of technology, regulations affecting cash management and the human and institutional capacity of the government.
- **Risk management:** The premier objective of a cash management unit is to safeguard the cash and investment assets of the government. Three primary kinds of risks include: financial risk including risks posed by financial institutions, market risk such as interest rate and exchange rate risks, and operational risk that includes fraud, misuse of funds and liquidity.
- **Internal controls:** It is important for the cash management unit to maintain and enforce internal control procedures specifically around account reconciliations, signature authorizations, and segregation of duties.

In many countries, the MOF will require MDAs to develop monthly (or quarterly) spending plans at the beginning of the fiscal year, which lay out their expected expenditures by month. Ideally, this plan dictates the amount of funds (apportionment) that will be transferred each month to the MDAs to cover their commitments. These spending plans should be adjusted regularly to reflect the most up to date revenue and expenditure information. If the government does not receive the receipts (revenues) originally forecast spending plans may need to be adjusted downward. If expenditures increased (e.g., construction delays), spending plans may need to be adjusted upward to seek additional funds.

Lack of a good cash management system can result in cash shortages, leading to the accumulation of budget arrears and/or cash rationing. Cash rationing occurs when the MOF provides MDAs with decreased apportionments than those in the approved budget or spending plans. Cash rationing can be responsible for significant dislocations in spending priorities relative to those that were agreed to in the approved budget. Cash rationing can also result in the approved budget becoming an unreliable predictor of resource allocations to MDAs and the actual expenditures by MDAs bearing little resemblance to the budget approved by the legislature.³³

³³ *Zambia: Public Expenditure Management and Financial Accountability Review*, The World Bank: 2004.

Figure 14: Good Practices for Cash Management

Key Characteristics of Good Practice in Government Cash Management³⁴

- Centralization of government cash balances and establishment of a treasury single account (TSA)
- Modern systems: an adequate transaction processing and accounting framework (processing government transactions with few handling steps, reliance on electronic transactions); modern banking, payment, and settlement systems
- Ability to make accurate projections of short-term cash inflows and outflows
- Strong institutional interaction, covering in particular:
 - Information sharing between the cash managers, revenue-collecting agencies and spending ministries (and any relevant ministry branch offices)
 - Strong coordination of cash and debt management
 - Formal agreements between the MOF and the central bank on information flows and respective responsibilities
- Use of short-term instruments (treasury bills, term deposits, etc.) to help manage balances and timing mismatches.

III.8.1 TREASURY SINGLE ACCOUNT

An essential tool for successful government cash management is a treasury single account (TSA). A TSA is a bank account or set of linked bank accounts through which the government transacts all its receipts and payments, and which allows the MOF to determine the government's consolidated cash position at the end of each day. According to the IMF, a TSA is one of the most important tools for reforming PFM systems in developing countries whose financial systems often rely on highly fragmented banking arrangements. Indeed, it is not uncommon for developing country governments to operate several thousand bank accounts, with each MDA operating several separate accounts.

Example: Egypt Before a Treasury Single Account

Before Egypt's government began instituting a TSA in 2010, the country had over 40,000 bank accounts (Source USAID 2010 Performance Report, Egypt).

Fragmented banking arrangements are suboptimal for several reasons. First, if MDAs are allowed to maintain their own bank accounts without access by the MOF, then the

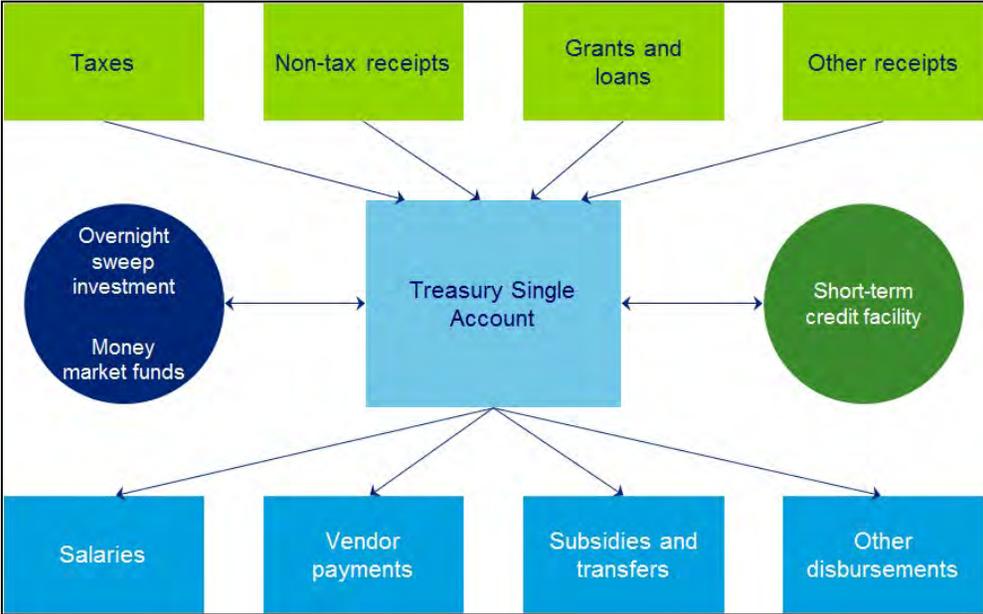
MOF will lack visibility into the government's consolidated cash position at any given point in time. Second, idle cash balances sitting in MDA bank accounts often fail to earn interest. Third, if the government is unaware of idle cash balances, it may unnecessarily incur borrowing costs to raise funds to cover a perceived cash shortage when in fact usable funds are sitting idle in another account. By consolidating government cash balances into one main account, a TSA gives the MOF/Treasury greater monitoring and oversight capabilities over all government cash flows.

Figure 15, which highlights the basic structure of a TSA, shows that all government receipts (e.g., tax and non-tax revenues, grants, etc.)—regardless of which entity collects those receipts—are transferred into the TSA and all disbursements (e.g., salaries, vendor payments, etc.) are made from the TSA.

³⁴ Mike Williams, *Government Cash Management: Its Interaction with Other Financial Policies*, International Monetary Fund Technical Notes and Manuals, 2010.

Ideally, all inflows into receipt accounts should be swept into the master TSA account (leaving receipt accounts with a zero balance) at the end of each day. Similarly, funds from disbursement accounts should be cleared out daily leaving these accounts with a zero balance at the end of the day.

Figure 15: The Structure of a TSA



Once the daily collections and disbursement amounts are captured, the cash management unit determines the net cash position of the TSA/government. If the day’s receipts are larger than disbursements, the TSA will have surplus cash for the day and if disbursements are larger, the TSA will have a deficit. Depending on the cash position of the TSA, the cash management unit may have to borrow money from a short-term credit facility to fund the deficit or may choose to invest the surplus cash into short-term investments in order to raise revenues (i.e., investment income) for the government.

Example: Nepal's Successful TSA Implementation

In 2011, Nepal initiated the implementation of a TSA. Within one year, the TSA had been rolled out to all central government ministries and was operational in 60 out of 75 districts. Through the District Expenditure Control System, the financial data for all MDAs in 67 of the districts is reported on a real time basis. The primary reasons for the swift and successful implementation include: political will of the MOF, strong IT skills available in Nepal, and ownership of the reform initiative by the Government of Nepal with strong collaboration with and financial support from the multi-donor trust fund. Financial staff in each of the MDAs is seconded from the MOF which helped build support for the reform. In addition, generators and solar panels were provided to district treasury offices to allow uninterrupted operations.

Implementing a TSA has several benefits for government cash management, including improved liquidity management, improved payment processing, improved revenue mobilization, and perhaps most importantly, improved internal control and accountability (see Figure 16).

Migrating to a TSA, however, poses several

challenges for many developing countries. Many countries lack the political will to invest the energy and resources required to make the transition from existing systems to a TSA. The task of identifying, reconciling, and closing of often several thousand bank accounts appears daunting to governments. MDAs may also view the establishment of a TSA as an expansion of central government control over government activities. Many developing countries also lack staff adequately trained to conduct active cash management as required by a TSA. Perhaps most importantly, many countries lack the banking environment, technological infrastructure, and supporting institutions (e.g., FMIS) to support a TSA. The lack of an adequate banking environment may be denoted by inadequate banking coverage across the country, particularly in more remote areas, banks may not have the systems in place to share information with the MOF (e.g., information on revenue receipts), and/or banks may only provide limited banking services.

As with any PFM reform, implementing a TSA should happen in stages according to the “as is” state of a government’s current cash management system. Some countries have found it useful to transfer certain disbursement categories over to the TSA first (e.g., salaries, capital expenditures, parastatals) with a full migration being phased in over time. Additionally, the introduction of electronic transaction processing (e.g., FMIS) and payment systems facilitates the establishment of a TSA.

Figure 16: Benefits of a TSA

Benefit Area	Specific Benefits
Improved Liquidity Management	<ul style="list-style-type: none"> • Effective control over aggregate cash balance • Improved cash visibility • Efficient and timely collection and disbursement processes • Improved debt management (realistic cash flow projection) • Significant cost reduction (transaction processing and interest costs)
Improved Payments Processing	<ul style="list-style-type: none"> • Single disbursement account (centralized TSA) • Low cost transactions • Facilitates payment automation through interfaces to operating systems • Allows utilization of modern payment services such as pre-paid cards, electronic funds transfer and direct deposits • Controlled disbursement accounts
Improved Revenue Mobilization	<ul style="list-style-type: none"> • More efficient collection of government revenue • Improved government services through enhanced transaction recording • Improved cash projection • Improved control against theft and fraud
Improved Internal Control	<ul style="list-style-type: none"> • Simplifies the government cash flow to only a few bank accounts, which means fewer bank reconciliations • Limits other agencies from opening bank accounts • Few individuals have access to checks, wires and other payment instruments • Clear segregation of duties
Improved Accounting Processes	<ul style="list-style-type: none"> • Automation of payments allows real-time recording of cash transactions • Allows automated daily reconciliation • Provides easily accessed audit trails • Increases reliability of accounting data

III.8.2 DEBT MANAGEMENT

When a government’s revenues do not provide adequate funds to meet its current or planned financial obligations, it may need to incur debt. Debt can take many forms, including short-term debt—for example, an overnight loan from the short-term credit facility—or longer-term debt, such as loans to fund capital projects. The type of debt instrument a government uses will be dictated by the purpose, timeframe, and specific purpose for which the debt is incurred. The most common types of debt instruments are loans taken out from capital markets or international financial institutions (IFIs) such as the IMF, and treasury bills and treasury bonds issued by the government itself.

The primary task of a government debt manager is to incur debt at the lowest possible borrowing cost. For many transitional economies, loans at concessional interest rates from IFIs are the primary sources of debt. Both advanced and developing countries seek funds from domestic and international capital markets. For many developing countries, domestic capital markets and banking systems are underdeveloped and therefore may not be a good source of financing.

Although it is expected that governments will take on debt to make investments or fund short-term deficits, prudent debt management is essential for reducing risks and managing costs over the medium and long term. The risks of excessive debt accumulation include: debt will become too large to repay; debt structures will be unsustainable in the long-term (i.e., low costs in the short-term but much higher debt service costs in the future); and/or that exogenous shocks will result in reversals of capital flows, cause currencies to fluctuate, or foreign assistance levels to drop.

Poorly-structured debt in terms of maturity, currency, or repayment terms, and large unfunded liabilities—as well as unsustainably high levels of debt—have been important factors in inducing or aggravating economic crises in many countries.³⁵ For example, if the maturity structure (i.e. length of loan/bond repayment) of the debt vehicle is inadequate, or if the interest rate terms are unfavorable then the likelihood for default is heightened. Similarly, if a government seeks a loan denominated in another country's currency (external debt)—such as if the Tanzanian government took out a loan from a Zambian commercial bank—and if the borrowing currency (e.g., Zambian Kwacha) were to appreciate (or depreciate), this could significantly affect the terms of the loan and its servicing costs.

Developing countries have been particularly affected by poor debt management, largely due to underdeveloped domestic financial systems, weak governance, lack of transparency and shortage of skilled debt managers. A 2006 report by the World Bank's Independent Evaluation Group noted that although countries had been given debt relief under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI), most of them still had weak debt management practices and functions.³⁶ A World Bank paper notes:

*"In most low income countries, the government debt portfolio typically comprises the largest financial portfolio; on average, public debt accounts for over 60 percent of GDP. If not properly managed, the structure of the debt portfolio may evolve in ways that could generate substantial risks to government balance sheets and affect the countries' financial stability. Further, the economies of lower-income countries are less diversified than those at higher income levels: export bases are narrower, exposure to recurrent commodity price shocks is higher, and reliance on limited and unpredictable aid flows for budget support is often heavier. All these factors make lower-income countries highly vulnerable to exogenous shocks that can significantly, and rapidly, worsen debt dynamics....The challenges faced by these countries highlight the need to identify and address weaknesses in debt management capacity."*³⁷

Leading practices in public debt management suggest a number of important reforms for developing countries, including developing a proper legal framework to support debt management, and centralizing debt management activities at the central level into one entity. This means that MDAs should

³⁵ *Independent Evaluation Group Report on the HIPC Initiative*, The World Bank: 2006.

³⁶ *Ibid.*

³⁷ Abha Prashad and Malvina Pollock, "Measuring Debt Performance: Key Findings from the Debt Management Performance Assessment (DeMPA)," <<http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1238442914363/5969985-1293636542096/DeMPANote201106.pdf>>.

not be able to incur debt themselves, and that any debt required to fund short-term deficits or capital projects should be managed centrally by the MOF. Historically, in many developing countries, MDAs have been able to incur or issue their own debt which led to unsustainable debt levels. While sub-national governments are legally distinct from central governments under federal systems, the central governments may be held legally responsible for the repayment of debts due to the implied sovereign guarantees to lenders and possibly, because of how national legislation is written. As a result, some countries do not allow sub-national governments to borrow or put controls in place on sub-national borrowing, e.g. requiring MOF approval prior to lending or limitations on the amount that can be borrowed.

Example: Local Government Borrowing in Albania

The Law on Local Government Borrowing of February 4, 2008, allows local government to borrow for cash flow and investment purposes. Loans can be obtained for:

- Short-term (less than one budgetary year): To finance temporary cash flow deficits when operational expenditures are higher than revenues.
- Long-term (longer than one budgetary year): To finance investment for public purposes and to cover local own or shared (with the national government) functions.

The rules that apply to short and long-term loans include:

- Short-term debt cannot exceed 10% of total actual revenues of the local government from local taxes and fees and shared taxes of the previous fiscal year.
- For long-term loans, the debt maturity cannot be longer than the useful life of the investment.
- The amount of debt service due in any year on all long-term debt cannot exceed 20% of the average total actual revenues of the local government from the equalization grants, shared taxes, and local taxes and fees of the previous fiscal years.

Additional leading practices include: appropriate sharing of information between debt managers, and fiscal and monetary authorities; transparency in debt management activities and appropriate accountability mechanisms; and the acquisition of necessary technological tools such as cash flow simulation models, means for debt recording, and reporting systems.

Another essential component of prudent debt management is risk management. A country should only take on an amount of debt it will likely be able to pay based on realistic assessments of its macroeconomic health, expected growth potential, and future revenue and expenditure forecasts. Maintaining sustainable levels of debt is important for withstanding exogenous shocks.

It is important to highlight that sound debt management in and of itself is not a substitute for sound macroeconomic and fiscal policies, and if not managed properly, debt can harm the larger economy. This is especially true for HIPCs and less developed transitional economies. These countries are at an earlier stage in their development, and as such continuing to strengthen their budget and cash management functions are priorities and requirements to build a proper foundation for conducting debt management.

III.9 Common Challenges

This section highlights the various challenges governments face when implementing the steps involved in the budget execution process.

III.9.1 ORGANIZATIONAL AND INSTITUTIONAL CHALLENGES

One of the key challenges facing developing countries is determining the appropriate institutional arrangements that will allow for the efficient and effective performance of budget execution processes. Most importantly, determining how responsibilities should be shared between the MOF and MDAs (centralized vs. decentralized systems). The MOF has a crucial role in budget execution and its role and level of control can be quite diverse depending on the country context. In more centralized systems, power is concentrated at the MOF (and central procurement unit) who manage procurements, commitments, and payments on behalf of MDAs. One of the key advantages of a centralized system is greater cost control; however this comes at the expense of less flexibility and longer approval times for MDAs. Ideally, the MOF should be responsible for tax and expenditure policies, and leave decision-making to MDAs. How governments arrange their systems on the continuum from centralized to decentralized arrangements should depend largely on the level of maturity of their PFM systems. From a PFM perspective, it may be appropriate for less-developed country systems to be more centralized and for systems to become more decentralized as they develop. However, consideration of political economy, conflict mitigation, diplomatic and governance issues may necessitate enhanced levels of devolution, deconcentration, or decentralization on an accelerated timetable.

III.9.2 CASH MANAGEMENT CHALLENGES

Another key challenge is cash management, including maintaining proper communication between an MOF and MDAs on reporting monthly and quarterly cash requests, based on budget allocations. Routine reports and cash flow forecasts to monitor performance is important for consistent service delivery targets and departmental or ministerial programmatic objectives. This is especially important in decentralized systems, where MDAs must track their own budget execution against planned expenditures, since they cannot rely on the MOF to cover excess obligations due to execution errors.

III.9.3 WASTE, FRAUD, AND ABUSE CHALLENGES

Anti-corruption monitoring and whistle-blowing mechanisms are important to safeguard the integrity of government financial operations, and challenges can arise when anti-corruption efforts are weak or not coordinated enough to ensure that complaints are heard and handled by the proper authorities. Challenges to anti-corruption efforts can occur when there are too many entities to report complaints to, resulting in complaints that are lost or never reach the intended authorities, or if anti-corruption efforts are not seen as confidential or autonomous. If anti-corruption agencies are not respected or deemed effective, there may be a tendency in some countries to be unwilling to share information across government agencies so internally MDAs may add internal controls of their own to handle corruption whose effectiveness may vary.

III.9.4 ADMINISTRATIVE PROCESS AND POLICY CHALLENGES

If methods like this are put in place, where additional procedures and controls are added, the traditional budget execution process can become so cumbersome that MDAs start consistently bypassing traditional expenditure channels in order to speed up processes. Many MOFs recognize this as a challenge and tolerate bypassing processes by using ‘accelerated or exceptional procedures’ for politically sensitive expenditures. Using such accelerated or exceptional procedures on a routine basis nullifies the effectiveness and necessity for occasional usage. Using these exceptional procedures that bypass standard controls make it more difficult to reconcile bank statements with budget accounts, and to obtain reliable information on cash expenditures. For example, if purchasing on credit when authorization has not yet been approved can occur, which makes it difficult to understand whether appropriations have been surpassed and if there is cash available to pay for purchases on credit after goods or services have been received and rendered. In cases like this, it is difficult to reconcile bank statements on cash expenditures with budget accounts, or to manage the financial position of the Government.

III.9.5 ACCOUNTING PROCEDURE CHALLENGES

Another common challenge is delays in recording transactions, disbursing funds, or collecting arrears. Many countries have trouble maintaining their accounting system and hiring and retaining qualified staff. Delays can lead to errors in recording transactions and reporting, or errors in registering transactions which can inflate or deflate budget availability. Delays could also occur because of monthly or quarterly financing constraints, forcing a MOF to slow down the payment process, either by delaying the issue of payment orders, or the cashing of checks because of limitations in the availability of funds. If a government delays disbursement of funds to later in the calendar year, but does not allow carrying-over funds across fiscal years, then problems can occur in spending committed funds before the end of the fiscal year. This may lead to wasteful or misallocated spending. If funds are disbursed late, and were not spent toward originally planned purposes, then an excess of funds prior to a cut-off date may exacerbate unnecessary or unplanned spending, or even lower rates of budget expenditure execution.

At a more macro level, it can be seen that many of the challenges in the budget execution process are interconnected. For example, the development of a commitment control system needs to be supported by measures in other areas, particularly on improving the budget formulation process and the introduction of an FMIS system with adequate procedures and enforcement. Similarly, effective cash management, including the avoidance of arrears or debt requires properly functioning commitment controls.

III.10 Implementing Reform

Budget execution consists of five essential phases: authorization and apportionment, commitments, acquisition and verification, payments and reporting. Effective budget execution assumes the establishment of controls so that funds are not misused and ensures that the budget is implemented as legally authorized to prevent abuse and corruption. Although any PFM reform package must be tailored to the specific needs of the given country,

there are several key international leading practices which are necessary for a properly functioning PFM system. The four key good governance practices according to the IMF³⁸ are:

- Every action is transparent;
- Every participant is held accountable;
- Every action is properly documented and reported; and
- Every action is subject to an independent, professional, and unbiased audit and review

A sound legal and political environment is necessary to support budget execution and accountability of activities. Strong legislation and well-documented policies can help remedy the challenges mentioned above, however, an equally strong tone-at-the-top and commitment by top management is necessary to enforce the adoption of sound and executed internal controls, prevent the proliferation of using exceptional procedures, register commitments on a timely basis, prevent arrears and perform routine bank reconciliations. The accounting system should be comprehensive and cover all MDAs. Finally, regulations should allow MDAs to carry over committed funds to the next budget year when justified.

The MOF must have authority and the will to rigorously ensure compliance with all legislation and regulations, and be transparent in disclosing information to all interested parties and stakeholders, including updates to laws or reporting practices. It should not continue to allow the usage of exceptional procedures to bypass traditional budget execution procedures and to unnecessarily expedite transactions. Instead, standard controls should be enforced and simplified if necessary. The budget execution process should be comprehensive to capture all budgetary funds so that no extra-budgetary spending can be authorized.

In terms of the roles of other oversight bodies, they should be strengthened and communication between oversight bodies should be strengthened. This includes anti-corruption entities, a public procurement regulatory body (that disseminates standard procurement related documents and trainings for both bidders and government agencies involved in procurement), and both internal and external audit bodies that are autonomous and well-established to follow-up on recommendations. All three types of entities will strengthen the public's ability to file complaints and to understand legislation and the budget execution process. A strong internal and external audit function that is well-respected will allow for continuous process and internal controls improvements. All of these functions, as well as those within the MOF, should have appropriate segregation of duties and oversight, to allow for checks and balances throughout the budget execution process.

Regarding cash management leading international practices, the adoption of a treasury single account is essential to reform. MOFs should be the only entity with the mandate to open and close bank accounts. This does not preclude MDAs from having bank accounts, but it does mean that the MOF has to have access to these accounts and that the accounts are incorporated into the TSA, including overnight sweep of funds. There should be a manageable number of bank accounts, and only enough to allow the MOF to effectively conduct treasury operations.

³⁸ *Guidelines for Public Expenditure Management*, International Monetary Fund: 1999, <<http://www.imf.org/external/pubs/ft/expend/guide4.htm>>.

In order to successfully implement a TSA, a well-developed banking system must exist. The retail banking network must cover all possible MDAs and must be able to provide modern services including zero balance accounts; online reporting, transaction processing and account reconciliation services; and direct deposits to bank accounts across a country. The payment process should be accurate and timely in capturing data flow and flow of funds. Accurate and timely data entered for every transaction is essential to transparency and legitimacy of financial data, especially to budgetary decision-making.

Communication across MDAs and oversight bodies is essential to transparency and understanding real-time cash management issues. Timely and standardized monthly and quarterly reporting across government entities should be adopted. A FMIS can be implemented to enable standardized reporting formats in accordance with international reporting standards. This means reports should be comprehensive, easy to understand, and timely enough so that management can use reports to change programmatic objectives and activities based on current financial information.

IV. Public Sector Accounting

Accounting is the process of recording, classifying, and summarizing the financial transactions of an organization. The data are then summarized in financial reports and statements that are useful for review and decision-making purposes. These documents are generally intended to be reliable indications of the financial status of the organizations accounts, and may be so under law. To ensure reliability, the information obtained from the accounting process must be accurate, timely and verifiable.

Business accounts focus on profitability and shareholder returns, while civil society organizations focus on achievement of their specific missions and sustainability. Ideally, governments focus on achieving broader public purposes within available budgets. As a result, public sector accounting is less about remaining a going concern than trying to ensure that resources are used efficiently, effectively, and transparently without waste, fraud, or abuse. Because government revenue largely comes from involuntary payments, a key objective of public sector accounting is to address the need for public accountability demonstrating to all governmental institutions and constituents that public funds have been used as intended.

IV.1 Basis of Accounting

The basis of accounting is the method and timing of recording transactions in the books and records. Governments adopt accounting standards to provide consistency and comparability across different public sector agencies within the country and to comply with accepted international practices for purposes of transnational comparability. The primary international standards include the International Public Sector Accounting Standards (IPSAS), Generally Accepted Accounting Principles (GAAP), and International Financial Reporting Standards (IFRS)³⁹. While differing in detail, all support moving from cash to accrual accounting. The three primary bases for accounting utilized in modern accounting are the cash, accrual, and modified accrual/cash basis.

“Top Three” Reference Materials on Public Sector Accounting

1. *Chart of Accounts: A Critical Element of the Public Financial Management Framework*, International Monetary Fund: 2011
2. *Strengthening PFM in Post-Conflict Countries*, World Bank: 2011
3. *International Public Sector Accounting Standards: Preface to the Conceptual Framework*, International Finance and Accounting Standards: 2012

IV.1.1 CASH BASIS ACCOUNTING

Under cash basis accounting, transactions are only recognized when money has been received or paid. The recording and reporting of transactions occurs when cash moves in or out of the MDA and/or its

³⁹ See definitions for IPSAS, GAAP, and IFRS in the Glossary.

accounts. Cash basis accounting is easy to implement, and accurately tracks cash on hand. If an MDA incurs expenses in one month, but does not pay the invoices until the next month, no expenses are recorded until the payments are made in the subsequent month. Similarly, if an MDA is owed payment, it would not record the income until the cash was actually received.

As a result, cash basis accounting does not necessarily fully correspond to actual expenses incurred and future earnings generated in a period. It does not provide a full picture of the financial implications of operations or available funds because it does not accurately reflect outstanding receivables, payables, assets, liabilities, and other obligations. Consequently, cash basis accounting is most suitable for households or small, simple businesses, rather than governments. However, due to its ease of use it is often used for governmental accounting despite its level of inherent inaccuracy.

IV.1.2 ACCRUAL BASIS ACCOUNTING

Accrual basis accounting records credits and debits as transactions are incurred, rather than waiting until cash is paid or received.

Accrual accounting provides a better picture of the financial condition of an MDA and

available funds and potential shortfalls against a budget or plan because it includes the financial implications of operations and a more accurate assessment of available funds. For instance, if an MDA agrees to buy some services, it records the liability (future expense) once a commitment is made to pay for services. It thus accurately reflects outstanding receivables, payables, assets, liabilities, and other obligations. Accrual accounting is more complex due to the specialized knowledge needed to accurately value assets and liabilities. Capacity-limited accountants and others may not understand accrual principles when compared to those used in cash basis accounting. However, accrual basis accounting provides a more correct picture of the financial condition of the MDA.

International Support for the Adoption of Accrual Accounting

In a letter dated June 15, 2010 to the G-20 nations, the International Federation of Accountants and IPSAS encouraged the adoption of accrual-based accounting as it reinforces the principles of transparency and accountability. The letter notes that “most significantly, the accrual basis for accounting records and reports assets and liabilities that are relevant to fiscal policy and long-term fiscal sustainability.”

IV.1.3 MODIFIED ACCRUAL/CASH BASIS ACCOUNTING

Modified accrual/cash basis accounting combines elements of the two systems. A cash basis is used for revenues, but an accrual basis is applied to expenditures, although there may be exceptions for specific purposes. This system recognizes revenues when they become available and expenditures as they are incurred. For example a government can recognize income when taxes are received because this meets the criteria of availability and measurability. When an invoice is received, the government records the expenditure, even if cash is not paid until a later date. This system increases government ability to control and monitor cash levels by restraining expenditures before revenues are actually received. In the United States, the GAAP for state and local governments uses the modified accrual/cash basis.

In other countries, the most commonly adopted standards for public sector entities are the International Public Sector Accounting Standards (IPSAS). The IPSAS standards are based on International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), but also combine certain aspects of cash and accrual accounting. IPSAS is considered to be the best practice in public sector accounting and has been widely

adopted by developed and developing countries. The latest compliance listings indicate fewer than 10 countries are fully compliant, but approximately 70 are partially compliant.

IV.1.4 TRANSITIONING THE BASIS OF ACCOUNTING

Cash basis accounting has been the predominant system used by most governments. However, there has been a growing trend to adopt accrual accounting in order to provide greater visibility into the use and management of public funds. Many governmental accounting systems may also retain cash basis accounting at different levels of government or for specific governmental organizations even when accrual based accounting systems are in use at the central level. Moving from a cash-basis to an accrual or modified-accrual basis system allows for more accurate budgeting and planning and can improve a government's ability to build and manage budgets that are realistic and based on experience. Under accrual based accounting, managers are accountable for assets and liabilities and must report on their financial position, cash flows, commitments, and contingencies.

Cash accounting has a short-term (1-year) focus while accrual accounting has a longer-term perspective to support a more useful time horizon for decision-making.

However, many developing countries continue to struggle to adopt accrual accounting basis systems. Systems, processes, and staff have often been set-up around familiar cash-based processes, and extensive revision of policies and procedures, guidance and staff training are required to implement accrual accounting. Transitioning from a cash basis to an accrual basis is often a multi-year process, gradually rolled out ministry-by-ministry.

Because the complexity of accrual accounting and capacity of the government may inhibit implementation of a full-accrual system, it is often best for developing countries to use a modified accrual/cash basis. If capacity to develop and implement a modified accrual system is limited, strengthening cash based systems is a viable temporary alternative when linked with efforts to increase capacity. When contemplating the transition to accrual or modified cash/accrual accounting, the following issues should be considered.

Scope, Timing, and Sequencing

Scope refers to the number of MDAs that will phase-in a new accounting method. While central governments may adopt reforms quickly, many countries experience difficulty implementing accrual accounting in decentralized, provincial or local governments or agencies that may have lower institutional capacity. Careful and comprehensive planning should be used to mitigate anticipated scope-related difficulties.

- A carefully developed plan is also needed for timing the transition, including planning, costing, monitoring, and evaluation. Policies and procedures will need to be revised, adopted, and implemented, and these must often include substantial capacity development operations.
- Specific sequencing of implementation as modified by both scope and timing must also be included in operational plans, with careful attention paid to issues of capacities, competencies, and the inevitable difficulties that will arise.

Examples of Transitioning to Accrual Accounting

One of the first countries to adopt accrual accounting was Chile in the mid-1970s, followed by New Zealand in 1990. By 2000, only six central governments had adopted the accrual basis for their annual financial accounts. In the U.S., the federal government adopted the accrual basis in 1997, but U.S. states and local governments only began adopting the accrual basis in the early to mid-2000s. In France, accrual accounting was adopted at the local level in the 1990s and in 2007 at the central level.⁴⁰

Human and Financial Resources:

- There may be resistance to change among management and staff. Key individuals must be “sold” on the benefits of transitioning to accrual or modified accrual accounting. Training will be required so that government accountants understand how to correctly record transactions under accrual accounting. The government can also consider hiring private accountants to assist in the transition to accrual accounting.

Computerization

- Computerization makes accrual or modified cash/accrual accounting easier to implement. MDAs will need to make decisions on whether the new accounting system will be manual, or fully or partly computerized. If computerized, will it be customized or use off-the-shelf software? An off-the-shelf system will be much cheaper and faster to implement, but may be less flexible and might meet all of the needs of the government or MDA.

Tax System

- The type of tax system may also influence the choice of accounting system basis. Accrual accounting is more applicable if most revenues are from income or property taxes because they are largely dependent upon billings and other less variable calculations. Tariff, fee and sales tax revenues tend to be more variable, and may thus be more easily managed through cash accounting. As most governments depend upon a mixture of these revenue types, revenue systems may need to use some form of modified accrual accounting even if the main accounting system used by a government is accrual based.

IV.2 Chart of Accounts

A chart of accounts (COA) is a list of all financial accounts used by a government including revenues, expenditures, and assets. The COA provides the structure of the general ledger, the primary accounting record of an organization, and is used in budgeting, recording transactions, and reporting. The COA contains the basic building blocks of an accounting system. It is critical for effective budget management, including tracking and reporting on

⁴⁰ *Accrual Accounting the Public Sector, CEDifo DICE Report 5*, Institute for Economic Research: 2007, <<http://www.cesifo-group.de>>

budget execution and evaluating results. It also serves to standardize governmental financial information and accounting rules so that government-wide statements can be consolidated.

The COA specifies how transactions are recorded in a series of accounts (general and subsidiary ledgers) using accounts and codes (the coding hierarchy structure) required to report financial transactions. Each account is assigned a unique identifier or an account number based on useful information tags. For example, these tags may denote the cost center (the department or unit responsible for the transaction), program or purpose, and nature of the transaction.

Coding is most effectively expressed through the use of numerical identifiers, which are essential for computerization of accounting systems. For example, an account beginning with “1” can indicate an asset, “2,” a liability, and “3,” equity. Subsequent digits in the identifier provide additional information on the transaction. While most countries do not have a standard or statutory chart of accounts for private sector organizations, most do have mandatory COA use requirements for governmental units to allow consolidation of government-wide financial information.

The COA may differ based on many governmental and regulatory requirements for internal and external reporting, budgeting, and cost tracking. Failure to adequately document requirements and design the COA accordingly can necessitate expensive re-engineering and result in poor data integrity. As the complexity of the COA increases, the reliability of data may decrease. A COA is more than an accounting exercise as it can be used to support good management and decision making. For example, proper segregation of expense accounts can lead to a clearer understanding of spending trends and facilitate greater understanding of an organization’s revenue needs.

Some key attributes a government should consider in designing a COA include, but are not limited to:

- Classification type (by fund, organization, location, program, and economic function);
- Budgeting and planning methods (cost versus activity-based budgeting);
- Linkage to international or mandatory budget classification frameworks;
- Stakeholder expectations;
- Regulatory requirements;
- Management and internal decision making needs;
- Logistical considerations; and
- Balancing cost and efficiency of the accounting system.

COAs should incorporate or be compatible with leading practices, such as the United Nation’s Classification of the Functions of Government (COFOG) and the IMF’s General Financial Statistics (GFS). COFOG and GFS, which are consistent, provide a system to classify, codify, and organize the basic functions of a typical government for budget and accounting purposes. Compliance is often incorporated into basic fiscal and/or budget laws and should be made mandatory as soon as practical.

COFOG and GFS are organized by government functions (e.g., general public services, defense, public order and safety, economic affairs). Each major category is separated into divisions and then classes. Each class has a description that describes the included activities. A government should use the COFOG to roll-up financial reporting and economic information. Compliance with the COFOG is mandatory for many multilateral development assistance programs, such as IMF reporting. COFOG only provides general guidance. Compliance can be achieved through the use of frameworks and manuals published by the United Nations and the IMF, some of which include transition guidance for reforms changing traditional accounting-based classification systems into COFOG/GFS-compatible systems.

It is important to note that adoption and implementation of functional classification compatible with COFOG/GFS is necessary for the effective implementation of MTEF and program and performance-based budget systems. Experience shows that sufficient allowances for compatible COA coding should therefore be made in the design phase of the COA and its coding hierarchy, or the implementation of these international good practices in budgeting and PFM will be substantially compromised, as may be the integrity of the COA and accounting systems.

IV.3 Financial Management Information Systems

Financial reporting is essential throughout the public financial management cycle as it provides valuable data to all stakeholders (including the public) and is a fundamental tool for managers and policy makers. Reporting allows stakeholders to hold the government accountable and facilitates better decision making by the executive and legislative branches. A FMIS is a powerful tool for supporting real time, meaningful financial reporting, and may additionally fulfill the computerization needs indicated above for a change to an accrual based accounting system.

A FMIS helps to automate key components of the budget execution and accounting processes and provides information to facilitate the budget preparation process. A FMIS stores and organizes real-time financial information for current and past year spending and approved budgets for the current year, detailed inflows and outflows of funds, and inventories of financial assets and liabilities. Controls can be incorporated in the FMIS to prevent overspending of the total budget of an MDA or specific sources and uses of funds, down to the line item level.

A comprehensive FMIS:

- Provides timely, accurate, and consistent data for management and budget decision making;
- Supports government-wide as well as agency level policy decisions;
- Integrates budget and budget execution data, allowing greater financial control and reducing opportunities for discretion in the use of public funds;
- Provides information for budget planning, analysis, and government-wide reporting;

Top Three Reference Materials on Financial Management Information Systems

- *Integrated Financial Management Information Systems: A Practical Guide*, USAID: 2008
- *Introducing Financial Management Information System in Developing Countries*, International Monetary Fund: 2005
- *Financial Management Information Systems: 25 Years of Work Bank Experience on What Works and What Doesn't*, Work Bank: 2011

- Facilitates financial statement preparation; and
- Provides a complete audit trail.⁴¹

The scale and scope of a FMIS can vary from a simple general ledger system to a more comprehensive system addressing budget, revenue, expenditure control, debt, asset and resource management, human resources, payroll, accounting, financial reporting, and auditing. A FMIS can be used across central government institutions or expanded to include local governments and quasi-governmental entities, such as parastatals; entities wholly or partially owned or controlled by the government.

The general ledger is the core of any FMIS (figure 15). It constitutes the primary accounting record. Every transaction entered into the system posts to (is entered into) the general ledger, starting with the allocation of budget funds and down to payments for goods and services. All transactions should simultaneously post to the general ledger and appropriate sub-ledgers following the rules contained in the standardized chart of accounts.

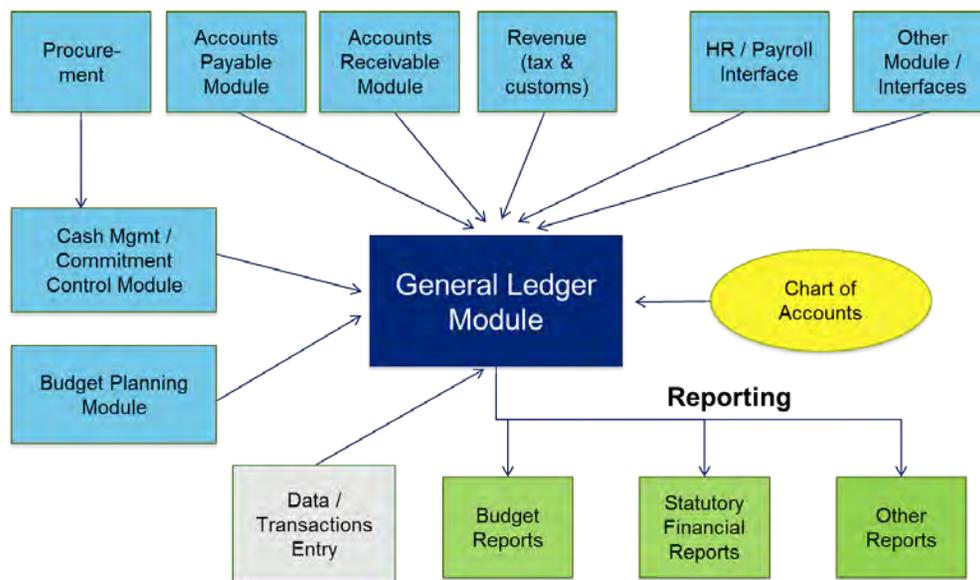
In addition to the general ledger, other core FMIS components and their main functions include:

- Budgetary accounting — Records the approved budget and any supplementary budgets, as well as transfers (also known as virements) made within legal thresholds.
- Accounts payable — Processes invoices for government expenditures, authorizes payments, and maintains a record of liabilities. Payments should be generated directly from the system.
- Accounts receivable — Processes all inflows received, including nontax revenues and fees.
- Commitment control — Ensures that there is sufficient cash allocated for an expense and the allocation matches the approved budget before a commitment to purchase is made.

It is important to note that the introduction of an IFMIS should also include planned provisions to integrate with partner country government efforts toward establishing e-governance systems. While the introduction of an IFMIS does not automatically resolve problems in either PFM or public accountability, the information that can be made available and the greater degree of verifiability of that information are necessary prerequisites for effective and accurate e-governance applications. If partner country systems, human resources, and infrastructure are either sufficiently developed or planned for development introduction of a linked, articulated, and comprehensive IFMIS may allow them to “leapfrog” or pass over intermediate stages in the development and implementation of effective e-governance systems. The availability of easily accessed and secure interfaces to the IFMIS would be of material assistance in this regard.

⁴¹ *Integrated Financial Management Information Systems: A Practical Guide*, USAID, 2008, <http://pdf.usaid.gov/pdf_docs/PNADK595.pdf>.

Figure 17: Typical FMIS Structure⁴²



There are a large number of other potential add-ons (non-core components) that can be included in an FMIS, including fixed assets, grants, budget planning and preparation, revenue administration, payroll and human resources, debt management, and grants management. Many different software platforms have been used internationally for FMIS, including Free Balance, Systems Applications and Products (SAP), EPICOR’s Enterprise Resource Planning (ERP), and Oracle.

The various modules and platform used in a FMIS often depends on other existing systems, such as the payroll system used, the capabilities of public financial management officials, and financial resources. Although implementation of an FMIS is an accepted good practice, many countries have struggled to implement a well-functioning system. Contributing problems include the lack of political will, resistance across the government bureaucracy, corruption and fraud, and weak human capacity.

A common problem in implementing a FMIS is being overly ambitious at the outset. Schick suggests that countries should “*Operate a reliable accounting system before installing an integrated financial management system.*”⁴³ Otherwise, existing problems are simply compounded. An FMIS should be tailored to the specific needs of the country. If the FMIS is too cumbersome, hard to maintain, or provides too much e detail, it will become

⁴² *Integrated Financial Management Information Systems: A Practical Guide*, <http://pdf.usaid.gov/pdf_docs/PNADK595.pdf>.

⁴³ Schick, Allen “Getting the Basics Right”

cumbersome and expensive infrastructure to service and its utility may be limited. Instead, FMIS configurations should be built gradually as employees and management gain the requisite skills and practices become more sophisticated.

Countries, and their donor partners, must be realistic about the time and money required to fully operationalize an FMIS. A 2011 World Bank study found that it took an average of 7.9 years to implement a FMIS at an average cost of over \$39 million dollars, including IT hardware.⁴⁴ Key success factors for implementing an FMIS are listed below:⁴⁵

- Strong leadership and a conducive political environment
- Attention to capacity building early in the process
- Adequate preparation
- Attention to FMIS priorities and sequencing

Example: Phased FMIS Implementation in Uganda⁴⁶

Uganda began implementing a pilot FMIS in March 2003 in six line ministries and four local governments. The second phase of implementation included the remaining line ministries and six additional local governments. The third and final phase will cover the remaining local governments.

Phased implementation of an FMIS has proven to be a successful approach for governments. Implementation can be gradually expanded to different users groups

and the complexity of the system can be increased as financial and human resources allow. For example, a country might begin implementing the core FMIS modules for the central government and then expand out to sub-national governments. Once the core modules are operational, a country can add additional modules as needed. Careful preparation and political commitment are critical, whether or not implementation is phased.

IV.4 Common Challenges

Some of the common challenges developing countries face in the design and management of their accounting systems and regulation are discussed below.

IV.4.1 WEAK REGULATORY ENVIRONMENT

Many countries lack a defined regulatory environment for accounting such as an accounting standards board, a supreme audit institution, and parliamentary enforcement ability. Accounting standards boards make crucial decisions to define accounting and reporting rules on the treatment of financial transactions and adoption of standards. They also provide a mechanism for discussion and feedback rules. Supreme audit institutions help to

⁴⁴ Demer Cem, Joanna Alexandra Watkins and William Leslie Dorotinsky, *Financial Management Information Systems: 25 Years of World Bank Experience on What Works and What Doesn't*, World Bank: 2011, <http://siteresources.worldbank.org/PUBLICSECTORANDGOVERNANCE/Resources/285741-1303321730709/WBStudy_FMIS.pdf>.

⁴⁵ Ibid.

⁴⁶ *Integrated Financial Management Information Systems: A Practical Guide*, <http://pdf.usaid.gov/pdf_docs/PNADK595.pdf>.

determine if the rules are being interpreted and utilized properly by ministries. Parliamentary enforcement fosters an environment where reporting and accounting weakness are corrected in a timely and effective manner.

The lack of legally mandated financial disclosure rules can result in disparate bases of preparation, inaccuracy, inconsistent presentation, or prevent consolidation of government-wide statements. This may reduce foreign investment incentives from donors and create unnecessary burdens on government capacity. Governments and stakeholders should ensure that regulatory mechanisms are put into place to create good accounting regulation to support transparency, reduce fraud, and ensure efficient utilization of public funds.

IV.4.2 LIMITED TECHNOLOGY

In the U.S. and Europe, MDAs often have automated information technology systems to plan and implement financial reporting. Developing country, governments must be aware of the cost and difficulty of implementing any new accounting system. In some developing countries, manual accounting processes performed on Excel spreadsheets or smaller, manual internal systems are used in place of integrated systems, inhibiting reporting and management oversight. These manual systems often suffer from poor document retention policies, insufficient audit trails, and poor controls over data entry. In designing a new automated system under these conditions, efficiency, judgment, transparency, and oversight will need to be built in from the start.

IV.4.3 LACK OF PROFESSIONAL ORGANIZATIONS FOR ACCOUNTANTS

Many developing countries lack professional organizations for accountants like the American Institute of Certified Public Accountants (AICPA). can provide significant benefit by creating a self-regulating accounting industry. They connect professionals, promote quality of accounting services, and conduct fora on national and international standards and practices. They can also operate certification systems and continuing education systems to increase the level of professional knowledge of public accountants, promote professionalism and credibility, and establish and enforce codes of conduct. USAID experience in supporting such organizations has generally been of assistance in supporting accounting reforms.

IV.4.4 HUMAN RESOURCES

Because of weak educational systems and resources and the lack of professional organizations, many developing countries have a small pool of well-qualified and experienced accounting professionals. Private companies often pull the best accountants from the public sector because they can offer better salaries and benefits. This may force government organizations to keep recruiting inexperienced or less well educated accountants and maintain extensive ongoing training. Government accountants often cannot keep up with the growing scope, techniques, and complexities of their work. The challenges of identifying, training, and retaining staff are generally worse at the sub-national level, where the public sector is competing with the national government as well as the private sector and local amenities and services are less developed.

IV.4.5 FINANCIAL RESOURCES

Financial resources for development, acquisition, and implementation of accounting tools and systems are often scarce in developing countries and affect the affordability of hardware and software and staff capacity development. Donor involvement has often been a key to the provision of additional resources.

IV.4.6 TAX SYSTEM

The structure of the tax system and how well it is enforced have implications for the type of accounting system. A poorly defined tax code or the inability to collect taxes can create a severe financial burden on governmental accounting capacity and these problems are often worse at the sub-national level.

IV.5 Implementing Reforms

There is no single blueprint for reforming public sector accounting and reporting. However, the International Federation of Accountants (IFAC) identified seven critical objectives for successful government financial reporting. Financial reporting should:

- Indicate that resources are obtained and used in accordance with the legally adopted budget;
- Indicate that resources obtained were utilized in accordance with legal and policy requirements;
- Provide information on how the government financed its activities and met cash requirements;
- Provide information on the sources, allocation, and uses of financial resources
- Provide information that is useful in evaluating the governments' ability to finance its activities and meet its liabilities and commitments;
- Provide information about the financial situation of the government and its units; and

- Provide information useful in evaluating the government's performance in terms of costs, efficiency, and accomplishments

Tanzania's Accounting Technology

Although the Government of Tanzania mandated the adoption of accrual accounting government-wide beginning in 2010, by 2011 not all local development authorities (LDAs) had access to the computerized accounting software, EPICOR, and some LDAs were still using excel spreadsheets. Moreover, even those LDAs that had the software lacked the necessary computer skills and hardware to use it well.

Measuring the effects of a shift from cash to

accrual or modified cash/accrual methods can be difficult. The problem is compounded when there is a lack of baseline data on accounting system performance. Useful performance measures for accounting reforms would focus on the results on decision-making; for example have the reforms enabled the government to best use funds more efficiently and effectively. Past reforms have revealed several key challenges and success factors.

TABLE 3: Challenges and Success Factors for Accounting Basis Transitions

Challenges	Success Factors
<ul style="list-style-type: none"> • Insufficient support for financial reforms; • Poorly designed implementation strategy; • Weak information and communications technology (ICT); • Absence of a pilot or phased approach; • Weak project management, monitoring, and evaluation); Unrealistic targets and goals; and • Lack of skilled resources. 	<ul style="list-style-type: none"> • Top-down” support for financial reforms; • A strategy that considers all stakeholders and defines critical COA design and reporting requirements; • Information and communication technology readiness; • Use of pilot programs and/or a phased approach; • Strong project management is in place and project champions identified; • Targeting small wins; and • Adequate financial and human resources to support the project

Some examples of qualitative performance measures to measure reform policies include:

- Are debt obligations reported fully, accurately, and on a timely basis? How?
- Do financial statements accurately reflect the government’s financial position including debt and other long-term obligations?
- Is there an increase in financial control and reduction in discretionary use of public funds?
- Is there an audit trail for all transactions?
- Are users able to understand and use reports to inform better budget and policy decisions?

V. AUDIT AND EVALUATION

An audit is a systematic and independent examination of data, statements, records, operations, and performance of a government for a stated purpose like regulatory compliance, operational effectiveness and financial accuracy. Audits involve collecting and analyzing sufficient and adequate evidence to support reliable financial reporting, efficient operations, and compliance with law and regulation. Audits also consider key risk factors facing government organizations and potential mitigation solutions. Donors and other external stakeholders commonly use audit reports to obtain reliable information on the operations and risks within an organization.

There are three primary types of formal audits serving different functions:

- **Financial:** Determine whether, in the auditor's opinion, the financial results were reported fairly in compliance in all material (significant) respects and provide a fair view of the organization's financial position, results of operations, and cash flows in conformity with local laws, regulations, or generally accepted accounting principles.
- **Compliance:** The extent that legal and regulatory requirements and donor and financial institution terms and conditions are being met and proper management systems and procedures are being used. Compliance audits may examine one or more programs or functions, to assess whether the organization is using resources appropriately and efficiently.
- **Performance:** Examine a program, operation, or process of an organization to assess if they are effective (achieving the desired results). Performance audits are a type of evaluation.

An area of concern for the independence of audit institutions is the practice of performing pre-audits to correct deficiencies in a more informal manner; this so that formal audit reports do not reflect inadequate or improper performance. These are fully distinct from the "pre-audit" of individual expenditures at the time of payment to ensure that they are executed in accordance with contracts, procedures, and rules. By performing pre-audits to enable informal actions to correct deficiencies, the level of accountability to executive and legislative entities and the public is compromised. In addition, since these pre-audits are often done at the behest of governments and directly involve the auditors in changing practices within executive branch entities, they compromise the independence of those auditors, as their reports become management tools rather than impartial evaluations.

Audits are also classified by the entity conducting the audit. **Internal audits** are conducted by the organization's own employees or personnel assigned to a permanent role in the organization. **External audits** are conducted by a third-party, such as the Supreme Audit Institution in the country or a professional auditing firm. Both internal and external auditors can provide all three types of audits.

Top Three Reference Materials on Audits and Evaluations

- *International Standards of Supreme Audit Institutions*, ISSAI and INTOSAI: 2013
- *International Standards for the Professional Practice of Internal Auditing*, Institute of Internal Auditors: 2012
- *Internal Audit: Finding its Place in Public Financial Management*, World Bank Institute: 2005

V.1 Internal Audit

An internal audit (IA) is “...an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”⁴⁷

Management and governing boards are responsible for the risks faced by an organization and adoption and implementation of controls to mitigate those risks. An Internal audit (IA) function provides assurance to management and stakeholders that the organization manages risks that might impede its objectives.

The internal audit function has been described as the “eyes and ears” of management. It includes periodic or on-going monitoring to assess how well the internal controls are functioning. Internal controls help to ensure orderly, ethical, and efficient operations, compliance with laws and regulations, and proper safeguarding of assets. In the public sector, it also means focusing on accountability obligations to donors and taxpayers. Some examples of items internal auditors may review include:

- Assessing the tone and risk management culture of the organization;
- Effectiveness and efficiency of internal controls;
- Proper segregation of duties within processes;
- Proper authorization of transactions;
- Safeguards over inventory and assets;
- Efficiency of processes or operations; and
- Accuracy of record keeping and documentation.

In recent years, internal audits have changed from a reactive function to a more proactive risk-based approach. A risk-based approach identifies factors that can jeopardize achievement of an organization’s objectives or mission and rates each risk based on the likelihood and impact of occurrence. The result is a portfolio view of risk that provides context to concerns and highlights significant trends or problems. Risks with higher probabilities or potential for interfering with the objectives or mission may be given a high priority for mitigation and monitoring. A risk-based approach enables an internal audit unit to anticipate. Internal auditors should be well versed in the strategic objectives of the organization and have a clear understanding of the operations of any given part of the organization as well as the bigger picture. The internal audit function is crucial to good governance and alignment of incentives and accountability for use of public funds.

⁴⁷ Web definition from the Association of Internal Auditors

V.1.1 INSTITUTIONAL ORGANIZATION

In the public sector, internal auditors typically either report directly to management and an independent board or serve as the arm of an external agency, such as an auditor general. Both arrangements have advantages and disadvantages in developing nations, as discussed below.

V.1.1.1 Internal Auditors Reporting to Management

Internal auditors who report to top level of management should have dual reporting to an audit committee (a body of non-executive, non-management members that oversees audit work plans and recommendations). The audit committee oversees the relationship management, sets the budget for internal audits, and ensures that the process and reports are free from interference by management. The internal audit committee also serves as a mechanism for reporting significant risks and keeping the function accountable with budgets and performance goals. This arrangement is common in countries without significant public sector accounting oversight bodies. Properly implemented, it can be an effective tool to encourage accountability and effective use of funds.

The Government of Rwanda uses this type of internal audit system. There is a standard internal audit charter used across all ministries and agencies that defines the purpose, authority, and organization required of each IA unit. While each internal audit unit reports to the management of their respective ministry, the Office of the Government Chief Internal Auditor (GCIA) oversees and co-ordinates the IA function throughout the government. The GCIA does not perform audits directly, but defines methods, policies, and initiatives to improve the quality of Rwanda’s public financial management systems.

TABLE 4: Advantages and Disadvantages of Internal Auditors Reporting to Management

Advantages	Disadvantages
<ul style="list-style-type: none"> • Easier to set-up than an independent government audit agency • May be more cost effective • Facilitates on-going monitoring and specialization within a specific institution • Direct access to management on an on-going basis can provide quick results • May allow audits to focus on value added and high-risk areas, rather than government legislated audits 	<ul style="list-style-type: none"> • Active audit committee required to prevent management interference with IA; • Inadequate implementation of follow-up activities from management; • Limitations on scope of audits; • Auditors may be sourced from inside they organization, which reduces independence from other staff.

V.1.1.2 Internal Auditors Form an Independent Government Body

Some countries rely on a single government agency to coordinate or conduct government-wide internal audit activities independent of the agencies audited. Budgets, hiring, and payment of the internal auditors are all handled by this organization. As a result, the auditors tend to have a greater degree of independence and may be more qualified, if the audits are well designed and adequately funded.

TABLE 5: Advantages and Disadvantages of Internal Auditors Forming an Independent Government Body

Advantages	Disadvantages
<ul style="list-style-type: none"> • Auditors are not paid, influenced, or managed by the organization being audited • Allows for rotation of auditors • Auditors do not have close ties with management or staff of the agencies audited • Empowered by legislation 	<ul style="list-style-type: none"> • May be difficult to setup and require legal statutes • Might not give adequate consideration to management initiatives Potentially less on-going monitoring and ministerial expertise since individual auditors may cover multiple agencies

V.1.2 CHALLENGES

Regardless of the choice of organization for the internal audit function, the following challenges should be kept in mind:

- Modern audit practices should rely on risk-based approaches to use scarce audit resources effectively. This is still often not the case in developing countries, where the internal audit function performs as another level of supervision of day-to-day operations (e.g., reviewing payments as they are made rather than ensuring that internal controls are in place and testing their effectiveness).
- In the absence of a true audit culture, audit reports might not be read by key officials and recommendations might not be followed-up on or implemented.
- The traditional model of public internal audits focused solely on compliance issues instead of reviewing performance in all aspects of government operations. Internal audits can be more useful if they address process design and efficiency in addition to internal control weaknesses.
- Too often, the executive branch or organization leadership interferes in the audit function to make it less effective. This can be done simply by minimizing the importance of the audit function through the "tone at the top", inadequate funding and staffing, or restricting the scope of the audits, and making the reports inaccessible.

V.2 External Audits

Unlike internal audits, external audits are performed by a firm or governmental body independent of the audited organization. External audits of public sector entities foster financial transparency and accountability and provide assurance to the government oversight bodies on operational integrity and financial reporting. These audits should be conducted in accordance with the guidance of the worldwide affiliation of SAIs, International Organization of Supreme Audit Institutions (INTOSAI). INTOSAI issues General Standards for Governmental Auditing and International Standards on Supreme Audit Institutions (ISSAIs).

V.2.1 INSTITUTIONAL ORGANIZATION

Supreme Audit Institutions (SAIs), financial enforcement bodies, ethics bodies, professional organizations, and parliamentary committees may provide oversight for the public sector. SAIs often have primary responsibility for external audits. They are independent of the government and provide the highest level of external audits. These organizations typically take the form of an auditor-general reporting directly to the legislative branch and funded as a line agency. This arrangement reduces the risk of undue influence on the audit process, withholding of resources or reports, and manipulation of the audit scope. The audits can either be performed directly by the SAIs or outsourced to independent firms. Regardless of the implementation option selected, SAIs should leverage international best practices codified in international audit standards and other similar frameworks to provide a basis for audit quality.

To be successful, SAIs should foster strong relationships in the wider government. They are most likely to be effective if the executive branch and legislature empower them fully and there are strong checks and balances between the executive and legislative branches. Typically, the Ministry of Finance has responsibility for implementation of the budget, while the SAI audits review the spending of all ministries to verify that funds were used appropriately and efficiently. The legislature will also need to recognize the importance of the SAI's work.

Common weaknesses in governments include insufficient institutional capacity and information sharing. SAIs, legislatures, and Public Accounts Committees (PACs) within legislatures often lack access to the expertise needed for auditing central banking institutions and other specialized ministries. SAIs and PACs also need a means to keep government stakeholders up-to-date on important issues and changing requirements and best practices.

V.2.2 CHALLENGES

There are many challenges in setting up an SAI:

- Some legislatures might not understand that adequately funding an SAI and adopting ISSAI can increase the efficiency and effectiveness of government, or may be more concerned about political ramifications or the potential for revenues from corruption.
- The ISSAI are complex and may be difficult to merge with local audit manuals and standards
- Priorities for external audits should be risk-based
- A weak follow-up process for audits may result in failure to implement the recommendations. Legislatures, SAIs, and PACs will need to ensure that significant risks are reduced
- Limited capacity of public and private sector accountants and auditors

To help reduce these challenges, SAIs should belong to INTOSAI, participate in its conferences, and stay current on its papers and promote professional development of their staff and contractors.

V.3 Partner Country Monitoring and Evaluation

Partner countries' own monitoring and evaluation policies for PFM are a vital ingredient in ensuring accountability and transparency, as well as being essential management tools. Routine budget reporting should include analyses of expenditures and revenues, and should be made publicly available, even if in a somewhat simplified form. This provides the opportunity to executive and legislative branch organizations, stakeholders, and civil society to accurately assess progress in budget execution.

In addition, partner countries that have progressed to recording and evaluating the performance of their programs should reflect these in periodic and annual reports, as well as incorporating them into budget submissions, medium term expenditure frameworks, and progress toward the achievement of strategic plan goals and objectives.

Not only will the use of such reports improve governments' ability to manage their operations and activities, but analytical and evaluative reporting forms the essential basis for an informed dialogue with citizens and other stakeholders about government achievements.

VI. STAKEHOLDERS FOR EFFECTIVE PFM

There are multiple stakeholders for effective public financial management in each country. Within the executive and legislative branches of government, different units may be responsible for the management, allocation, accountability and use of public financial resources. These units' functions are usually and necessarily intertwined. Stakeholders also include civil society organizations, the private sector, the media, and the general population. Although no two countries are alike, some of the common types of stakeholders are discussed below.

In any discussion of PFM practices, stakeholders, and organizations, the concept of function is most important. The names of institutions or individual roles are not as important as evaluations, both of the political economy of the country and of which roles or functions each institution executes. As an example, in Australia the functions of a Ministry of Finance are largely performed by their Treasury – but the functions are still performed, as they should be in any effective state. Effective development assistance should follow the knowledge gained from understanding government functions and structures, no matter what the names of those organizations are.

VI.1 Executive Branch

The **Ministry of Finance** is the central stakeholder responsible for fiscal policy, tax administration, budget formulation and execution, accounting policy, FMIS, internal controls, and financial reporting. There are various models for the internal organization of an MOF, but coordination with MDAs and sub-national governments and clear delineation of each institution's responsibilities are critical. Although treasury functions are often performed by a sub-unit of the MOF, some countries have a separate **Treasury** at the cabinet or sub-cabinet level.

Some countries have a **Ministry of Planning** separate from the MOF. Because of the importance of linking planning and budgeting, many countries combine these two roles in a single Ministry of Finance and Planning. In generally, many countries have been moving away from a highly centralized planning system in favor of indicative planning. With this approach, the **Ministry of Planning** focuses on long-term strategic vision and determining the most pressing priorities giving each MDA responsibility for developing their own plans.

Some countries have a separate **Ministry of Economy** that performs functions that are assigned to the **Ministry of Planning** in other countries. However, these functions are more commonly assigned to the **Ministry of Finance**. These functions may include macroeconomic analysis and planning, capital budgeting and public investment programs.

The MOF collaborates with all MDAs in the budgetary process. Typically, the initial budget preparation work is done by the agencies responsible for the execution of the budget, often in collaboration with agencies at the sub-national level. Agency budget requests must fall within the guidelines set by the central budget authorities. The MOF subsequently manages the flow of funds and monitors execution to ensure compliance with the budget. Depending on whether the accounting system is centralized or decentralized, the MOF will either record expenditures or an MDA will record its own expenditures and be responsible for its own accounting.

Executive leadership within the **Office of the President or Prime Minister** is responsible for setting national strategies and priorities. Budget allocations should reflect these priorities. In some countries, the President or Prime Minister submits budgets, with the support of a **Central Budget Office**, to the

Legislature. A strong system usually starts at the central level and then flows down to the regional or local level, where budget execution, procurement, design, and implementation occur.

There may also be designated bodies at the executive level that promote fiduciary accountability through spending controls or audit responsibilities. Some countries have an **Anti-Corruption Agency** with enforcement and investigative powers to help ensure transparency and prevent the misuse of funds. The Supreme Audit Institution provides accountability by reviewing the government’s revenue collection, spending, and reporting to the legislature. SAIs should produce timely reports, foster financial transparency and provide assurance to oversight bodies. Government institutions are subject to various kinds of audits, including financial, compliance, performance, ethical, and value for money. . However, the extent of independence of the SAI is a critical issue in many developing countries.

Ideally, the **Central Bank** will be independent, but in some countries, it is under the control of the legislature. The Central Bank should have a central role in producing macroeconomic forecasts that are the basis for tax revenue estimates and holding the cash flows of the treasury and other government accounts.

Table 6 below provides an illustrative list of executive stakeholders that promote PFM through operational and functional capacities or help to ensure accountability.

TABLE 6: Executive Branch PFM Stakeholders

Operational and Functional	Accountability
<ul style="list-style-type: none"> • Ministry of Finance • Ministry of Planning • Central Budget Office • Central Procurement Unit • MDAs (budget, accounting and procurement units) 	<ul style="list-style-type: none"> • Supreme Audit Institution • Anti-Corruption Agency • Procurement Regulatory Body • Financial Disclosure Enforcement Entity • Ethics Body • Internal Audit Units

VI.2 Legislative Branch

Some countries have reduced the role of the executive branch while increasing the role of the legislative branch as their PFM systems mature. In these countries, the legislative branch has taken a larger role in the design of PFM systems and approval and oversight of the budget. An effective legislature can hold the executive branch accountable and oversee government performance. Many national constitutions require legislative approval of appropriations and tax laws.

Good practice in PFM includes a separation between the institutions that authorize funding through appropriations and those that expend the funds authorized. As a practical matter, this separation is most easily and correctly accomplished by the legislative bodies approving the executive budget and its supporting documents independently, even if the budget is prepared and submitted by the executive branch. This additionally improves accountability to the citizens and other stakeholders in systems where legislatures are democratically elected. Since many legislatures lack the staff

and/or capacity to evaluate and analyze government budget submissions, these functions can be materially strengthened by the creation of legislative fiscal analysis units and staff. Not only is this good development practice, but it has been successfully done in any countries.

The legislature can also help ensure the transparency and legitimacy of budgeting and budget execution. Legislative involvement is particularly important in establishing budgetary reforms, addressing fiscal consolidation, and reviewing program results. However, many legislatures have limited resources and capacity to analyze the draft budget law carefully. In many countries, legislative decisions on budget proposals or public finance are prepared by a Standing Committee on the Budget and Public Finances. Many legislatures, especially in former British colonies, have a Public Accounts Committee responsible for oversight of the financial and performance accountability of executive branch agencies. Countries vary in the amount of control given to legislatures to intervene in public financial management. There have been concerns in some countries that too much legislative intervention can stifle the executive branch's freedom to act. However, where the legislature's role in public financial management is weak, the executive branch is more likely to abuse its power.

VI.3 Other Stakeholders

Many other actors can influence PFM through formal or informal means. These external stakeholders can include non-governmental organizations (NGOs), civil society, the private sector and the media. Although these groups may not have the same level of authority and often have varying interests, collectively they can influence decisions on how public funds are spent and managed due to their influence over the general public and specific public groups. Formal budgeting processes have traditionally excluded these actors, but they have become more prominent and effective in analyzing and influencing public budget preparation and execution in many countries.

NGOs and civil society organizations (CSOs) help their publics understand the government's stated and actual priorities, advocate for alternatives, and bolster or undermine confidence in the government. Political scientists use the term "publics" to recognize that there are multiple diverse interests of different groups. CSO engagement in public budgeting can increase the transparency of budget decisions and implementation. CSOs can be a source of independent information for the impact of the budget on disadvantaged groups, including low-income people and other marginalized groups. Furthermore, CSOs can increase the publics' understanding of budget and policy issues. CSOs can also be effective in collecting, synthesizing, and disseminating information on public finance, where budgets and government actions are transparent and the media are free.

Civil society organizations are now playing an increasing role in budget decision-making and implementation in over 60 developing countries in Africa, Asia, and Latin America. For example, "Fundar" (Center for Research and Analysis), a local NGO in Mexico, works with a coalition of CSOs to strengthen the government's commitment to reducing maternal mortality. Similarly, the Uganda Debt Network has helped to reduce corruption and conduct research on the quality of health and education expenditures.⁴⁸ There has been much less CSO engagement in auditing agency budgets and

⁴⁸ Vivek and Warren Krafchik Ramkumar, *The Role of Civil Society Organizations in Public Financial Management and Auditing*, The International Budget Project, <<http://www.internationalbudget.org/wp-content/uploads/The-Role-of-Civil-Society-Organizations-in-Auditing-and-Public-Finance-Management1.pdf>>.

expenditures, although many international organizations have been pushing for increased coordination between civil society and supreme audit institutions. Although CSOs may be at odds with government decisions at times, they provide an essential check on PFM powers due to their ability to publicize government activities and public procedures.

VII. SEQUENCING PFM REFORMS

The Paris Declaration on Aid Effectiveness (2005) confirmed donor commitment to some key reforms for public financial management:

- Strengthening partner country development strategies and. planning, budgeting, and performance;
- Increasing alignment of aid with partner country priorities, systems, and procedures and helping to strengthen their capacities;
- Enhancing donors and partner country accountability on development policies, strategies, and performance to their citizens and legislatures;
- Eliminating duplication of efforts and rationalizing donor activities to make them more cost-effective;
- Reforming and simplifying donor policies and procedures to encourage collaboration and align with partner countries' priorities, systems, and procedures; and
- Defining measures and standards of performance and accountability for PFM, procurement, fiduciary safeguards and environmental assessments, in line with good practices, and helping to ensure their timely application.

Top Three Reference Materials on Sequencing PFM Reforms

- *Principles for Sequencing Public Financial Reforms in Developing Countries, International Public Financial Management Review: 2010*
- *Background Paper 1: Sequencing PFM Reforms, IMF: 2013*
- *Public Sector Reform: What Works and Why? World Bank Independent Evaluation Group: 2008*

In the aid effectiveness conferences in Accra, Ghana (2008) and Busan, Korea (2011) further commitments were made to deepen and broaden the measures agreed to in Paris. Participants agreed to:

- **Enhance Ownership:** Countries should have more say over their development processes through wider participation in development policy formulation, stronger leadership on aid co-ordination and more use of country systems for aid delivery. In Busan, the non-governmental sector was also added, along with other non-traditional development support, as stakeholders in development processes.
- **More Inclusive Partnerships:** All partners - including donors on the OECD Development Assistance Committee and developing countries, as well as other donors, foundations and civil society – should participate fully in development. Busan added an emphasis on South-South and triangular cooperation as well as using the diverse resources offered by non-governmental and non-traditional actors.
- **Deliver Results:** Aid should be focused on real and measurable development impacts, which should be concrete and sustainable. Successful initiatives should be scaled up, and a general improvement in managing for results, communications, and monitoring and evaluation is necessary.
- **Strengthen Capacity Development** - The ability of countries to manage their own future should be central to development. Not only should their capacities be developed, but developing countries should be encouraged to engage with diverse sources of development funding and activities.

As donors adhere to these commitments, they are reexamining how they provide assistance and consequently how best to strengthen partner countries' public financial management systems.

VII.1 PFM Assessments

Before developing a sequencing strategy for PFM reforms, it is important to know the baseline and problems associated with the current system. Common assessment tools and processes for identifying the baseline and problems include the Public Expenditure and Financial Accountability (PEFA) assessment⁴⁹, the Public Expenditure Review (PER)⁵⁰, the Country Financial Accountability Assessment (CFAA)⁵¹, USAID's Public Financial Management Risk Assessment Framework (PFMRAF)⁵², and DFID's Fiduciary Risk Assessment (FRA)⁵³. Although the PFMRAF and FRA were designed to assess the donor's risk in providing G2G funding, they are also effective tools for identifying areas where PFM reforms are needed.

The PEFA is the most widely used diagnostic tool for public financial management. It consists of 28 high-level indicators for budget credibility; comprehensiveness and transparency; policy based budgeting; predictability and control in budget execution; accounting, recording, and reporting; and external audits. The PEFA assesses current PFM performance and generates grades from the evaluation team that are negotiated with the partner country government for each indicator to benchmark a country's PFM performance against good practices. However, the PEFA does not include recommendations for specific reforms or action planning.

The PEFA can be used to identify PFM reform needs for discussions or planning purposes. The summary findings table provides grades and brief descriptions of the findings on the 28 indicators. Indicators with grades of C+ or below should be evaluated for priority reforms. If the grades are B- or higher levels, areas should undergo further review if the partner government considers them priorities. The need for assistance can be further evaluated using the documentation that supports the PEFA grading. The selected items can be combined with the recommendations to generate priorities for potential actions and sequencing. These findings should then be discussed with the partner government in a bilateral meeting or a joint meeting if donor coordination has been established for PFM topics. An advantage of using the PEFA in this manner is that the partner country government will already have been involved in discussions and reached agreement with the PEFA Team on the grades.

⁴⁹ The PEFA, originally developed by the World Bank and now self-managed with their support, is an internationally accepted tool. The results of a PEFA are discussed, negotiated and agreed with the assessed country prior to issuance. It evaluates PFM system quality and deficiencies but is not formulated to assess risk or generate risk mitigation measures.

⁵⁰ The PER is a World Bank process to assess PFM and to assist the client country in reforming public expenditures by identifying needed reforms. Its specific focus is on developing programs for PFM problems that can be associated with the Bank's Country Assistance Strategy.

⁵¹ CFAAs are a key diagnostic tool to describe the financial accountability arrangements in countries' public and private sectors with the objective of strengthening these environments. CFAAs support both the exercise of the Bank's fiduciary responsibilities and the achievement of its development objectives through assessing the strengths and weakness of countries' accountability arrangements and identifying the risks that these may pose to the use of Bank and other public funds.

⁵² The PFMRAF is a broad-based series of assessments of a country's PFM and public accountability environments to inform decisions on whether government to government assistance is appropriate. As such, it focuses primarily on mitigation of USAID's fiduciary risks in providing direct funding support to the partner country government.

⁵³ DFID's FRA is, like the PFMRAF, designed to assess fiduciary risks. They are generally confined to a single sector or program.

USAID's Public Financial Management Risk Assessment Framework (PFMRAF) is also useful for informing reform need determinations. Its focus on risk is complemented by that of DFID's FRA. Evaluation teams may take a different approach, resulting in slightly differing recommendations. Either or both of these risk assessments can be used to assess the need for improvements, and serve as a basis for discussions with the partner government to help them produce their PFM reform strategy. For USAID, a Stage 2 PFMRAF or other assessment by implementing partners in technical assistance projects can be used to generate further information at an enhanced level of detail to aid in program design.

All available assessments should be reviewed, although those invalidated by changes in governments or systems may be discarded.

VII. 2 Sequencing Approaches

The most effective sequencing of PFM reforms has been widely debated since developing countries generally cannot tackle all recommended reforms at the same time. While there are some useful models and basic principles, there is little empirical evidence or research on which approaches are most effective and efficient.

Bietenhader and Andreas Bergman noted three conceptual approaches for sequencing PFM reforms:

1. Basics First;
2. Platform Approach; and
3. Evolutionary Approach⁵⁴

VII.2.1 BASICS FIRST

Schick (1998) recommended ensuring that initial assistance is focused on implementation of fundamental good PFM practices. Countries with low capacity should focus on implementing the basic laws, policies, and practices that underpin good practice PFM before attempting to introduce the more sophisticated PFM practices used in developed countries. He suggested:

- Government should foster an environment that supports and demands performance before introducing performance or outcome budgeting;
- Inputs should be controlled before seeking to control outputs;
- Governments should be able to properly account for cash before trying to account for accruals;
- External controls provided by the MOF should be established before MDAs introduce internal controls;
- Internal controls should be established before focusing on managerial accountability;

⁵⁴ Daniel Bietenhader and Andreas Bergman, Principles for Sequencing Public Financial Reforms in Developing Countries, International Management Review, Volume 11, Issue 1, 2010.

- A reliable accounting system should be established and in operation before installing an integrated financial management information system;
- Good budget processes should be in use before implementing budgeting for results;
- Formal private sector contracts should be enforceable before introducing performance contracts for the public sector;
- Effective financial auditing is necessary before introducing performance auditing; and
- Predictable budgets should be adopted and implemented before insisting that managers apply budget-linked efficiency strategies to their resource use.⁵⁵

A World Bank study suggests that the “basics first” approach to reform has been successful in many countries, including Bulgaria, Guatemala, Sierra Leone and Russia.⁵⁶ For example, Guatemala first emphasized improving budgeting, accounting and cash management, which provided a firm foundation for PFM that contributed to the success of later reforms. Getting the basics right allowed for effective reform even where governments’ technical or political capacities were weak. However, some PFM specialists contend that getting the basics right does not necessarily or sufficiently encourage and/or facilitate progression to more complex strategic reforms, while adding significantly to the length of engagement in the delivery of development assistance.

VII.2.2 PLATFORM APPROACH

Under the platform approach, PFM reforms are implemented sequentially in series of packages (“platforms”), rather than as individual measures. Each of these platforms is designed to have clearly defined outcomes and constitute a step toward adoption of the next package. Proponents of the platform approach argue that it leads to more comprehensive and sustainable PFM systems than the basics-first approach. Properly designed platform approaches disaggregate reform steps so that each can reasonably be expected to be sustainable, effective, and desirable within each platform. Thus, even if subsequent reforms are delayed or abandoned their incremental precursors remain and benefit the partner country’s PFM system. Success is not only equated with progress toward comprehensive reforms, but is also defined by the sustainability of each of the incremental reforms implemented prior to the achievement of the end goals of the reform strategy.

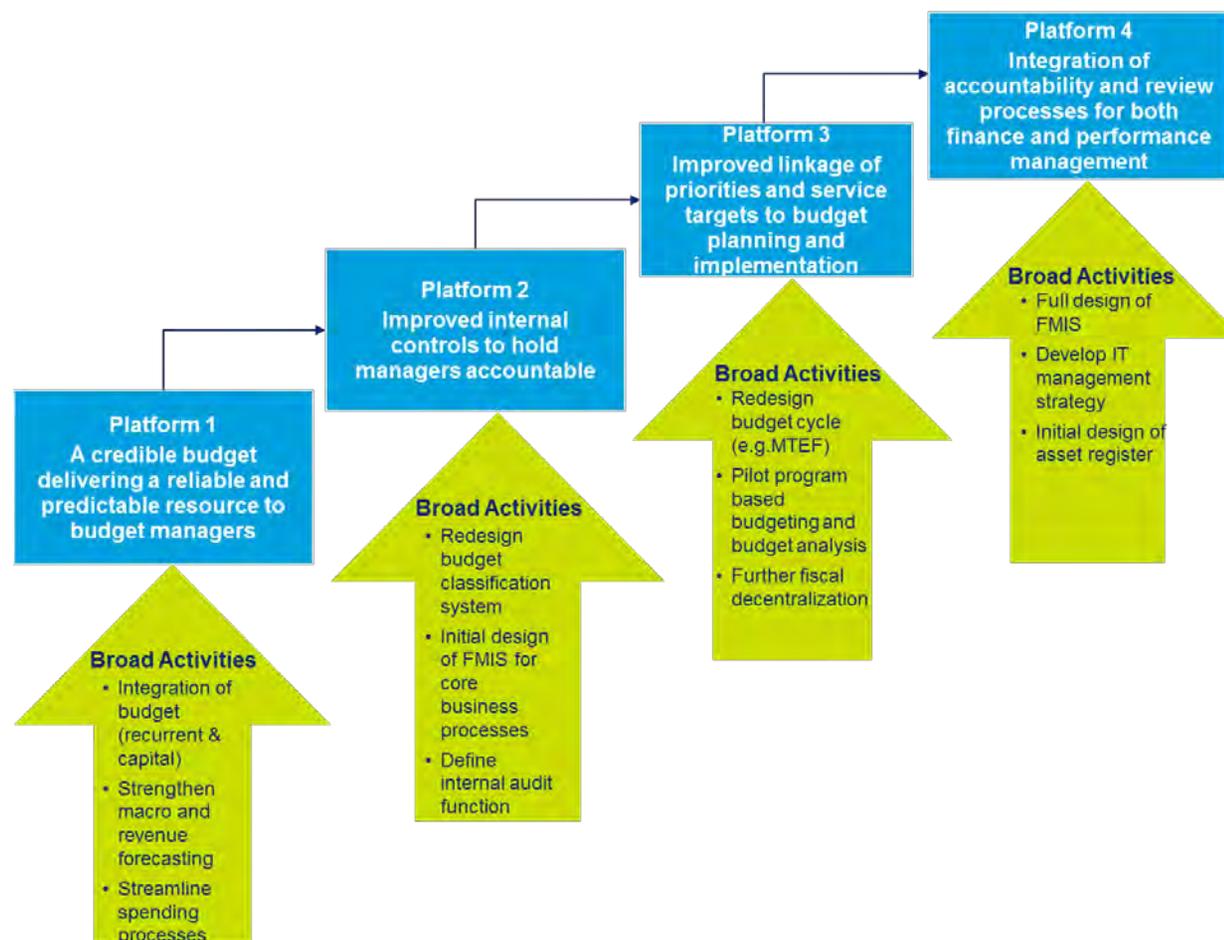
Cambodia used the platform approach successfully. Its reforms were packaged into four platforms and various activities to achieve them (Figure 18). The platform approach helped the Cambodian Ministry of Economics and Finance focus on defined priorities and a manageable set of tasks. The sequencing of the platforms allowed time to build momentum for further reforms and for management and staff to absorb and institutionalize the reforms. However, if the platform approach is donor driven, partner countries may have difficulty reaching agreement with donors on the components,

⁵⁵ World Bank. 1998...*Public Expenditure Management Handbook*, Washington, DC World Bank, <<http://www1.worldbank.org/publicsector/pe/handbook/pem98.pdf>>.

⁵⁶ “Public Sector Reform: What Works and Why?” World Bank Independent Evaluation Group: 2008. <<http://web.worldbank.org/WBSITE/EXTERNAL/EXTOED/EXTPUBSECRETF/0,,menuPK:4664077~pagePK:64829575~piPK:64829612~theSitePK:4663904,00.html>>.

definitions of success, and timing of each stage. For example, Cambodia experienced significant delays in implementation of its platform approach, necessitating a “reboot” of the process due to insufficient political commitment caused in part by the donor-driven nature of the reforms.

Figure 18: Platform Approach to Sequencing PFM Reform



Source: Daniel Bietenhader and Andreas Bergman, Principles for Sequencing Public Financial Reforms in Developing Countries, International Management Review, Volume 11, Issue 1, 2010.

VII.2.3 EVOLUTIONARY APPROACH

The evolutionary approach is based on the assumption that gradual implementation of reforms is necessary to achieve sustainability and lead toward more complex reforms that focus on outputs and outcomes. It differs from the platform approach in the activities included in each stage. It also emphasizes a systems approach within each platform, rather than piecemeal actions.

The evolutionary approach is a variant of the platform approach with three sequential steps:

1. **Transaction Platform** – The budget system, accounting, disbursement systems, and their supporting computer systems to facilitate efficient financial control;
2. **Policy/Performance Platform** – The macro-economic framework, budget policy and strategy, intergovernmental transfer formula, multi-year budget planning, and a management information system; and
3. **Legislative Oversight Platform** – The processes of policy development, appropriation, and expenditure evaluation.

VII.2.4 THE USAID INTEGRATED PHASE APPROACH

Based on USAID and other donors' experience in the provision of PFM development assistance, the preceding three approaches offer important insights into the sequencing and delivery of PFM reforms. However, these approaches are narrowly focused upon assistance in the PFM sector, while USAID's efforts to improve PFM must also integrate sectoral efforts with those in local systems development, local solutions, and the full range of sectoral assistance provided by the Agency. USAID should include the principles of the "basics first" approach, the goal-oriented structure of the "platform" approach, and the integrated PFM system considerations of the "evolutionary" approach into program designs. Program designs must also be prepared in accordance with Agency strategic planning and programming principles and procedures and should integrate the imperatives of non-PFM sectors. USAID also recommends disaggregating and sequencing each group of activities for greater potential effectiveness, efficiency, and sustainability.

In designing programming under the IPA approach, emphasis should be placed on the sustainability of incremental reforms and milestones should include provisions on the utility and sustainability of actions taken to achieve them. In effect, as in properly designed platform approaches incremental reforms should be severable for sustainability; that is they should be structured so that even if reforms stop with that increment they will have advanced the efficiency, effectiveness and utility of the partner country's PFM system as well as acting as prerequisites and foundations for further reforms. As indicated below, this approach to incremental reforms may be vital to integrating reforms, or partial reforms, previously implemented by partner countries. This will help to ensure the sustainability of those reforms as well as inform the monitoring and evaluation processes needed for effective USAID programming.

In order to accomplish these objectives USAID PFM programs should apply an **Integrated Phase Approach (IPA)**. Each phase must be integrated across sectoral boundaries, focused on accomplishment of system or sub-system reforms, and have clearly identified and realistic goals, milestones, and targets. Many of our prospective partner countries have already accomplished some of these identified goals, milestones, and targets and each has its own context to be considered and priorities for specific reforms and actions that are already completed or underway. It may thus be necessary to modify the reforms in a phase after careful assessments and agreement with partner country authorities.

IPA includes five phases:

1. **Assessment Phase:** All available and reliable assessments of the environment for PFM and governance should be evaluated. If G2G programming is a possibility, a Stage 1 PFMRAF should be completed. If a recent political economy analysis (PEA) performed by the World Bank or other donors is available, this should be used to understand the major actors and economic, fiscal, and political factors affecting PFM. If a PEA is not available, it is advisable to perform one.⁵⁷ Additional required analyses include a sustainability analysis under provisions of ADS 201 and a Democracy, Human Rights, and Governance (DRG) Assessment per ADS 220 if a PFMRAF is required. Prepare a brief report synthesizing the results of these assessments and analyses for use in discussing programming issues with the partner country government and donors.
2. **Planning and Strategy Phase:** Hold discussions with the partner country government and other existing or potential major donors on PFM issues. **Encourage and/or assist the partner government to generate a PFM reform strategy incorporating actions to implement reforms or enhancements identified in the assessments and broadly compatible with the IPA.** This strategy is necessary to ensure partner country commitment to and planning for PFM activities. The strategy should be formulated by the government in cooperation with stakeholders, USAID and other donors. Integrate the partner government's PFM strategy and the findings of the assessments into the Country Development and Cooperation Strategy (CDCS), and follow USAID policies and procedures through the Project Appraisal Document (PAD), with additional inputs and assessments as required. If PFM activities cannot be derived from the current CDCS, amendments may be needed.

Consider the potential for partner country institutions to implement PFM reform initiatives in cooperation with the Mission as G2G projects with effective risk mitigation and/or other capacity development activities. This assistance could include sequenced TA that supports an eventual goal of transferring knowledge and operational responsibility to partner country systems and entities.

3. **Core Systems Phase:** Basic or core PFM systems should function effectively and efficiently prior to the introduction of more advanced reforms. The core systems phase, like the Evolutionary Approach, concentrates on ensuring financial transaction systems operate effectively. In the Integrated Phase Approach, substantial elements are also aimed at improving governance capabilities and the legal framework. The amount of time needed to complete this phase varies, depending on how long it takes to secure the necessary political support and the sensitivity to the enhancements recommended. Often many of the system improvements have already been implemented. The core systems phase should address the legislative basis, budget planning and development, transactions and budget execution, revenues, public administration, and auditing:

⁵⁷ For further information on performing a PEA, see forthcoming guidance from the USAID Democracy, Human Rights, and Governance Center of Excellence.

- a. **Legislative Basis:** The legislative basis for PFM and governance reforms may be an essential prerequisite for systemic PFM enhancements.
 - Budget laws for central and local institutions should be complemented by laws that cover planning, transparency/freedom of information, public involvement and accountability, banking, and business regulation. There may additionally be changes in the competencies and/or organization of government needed to enhance PFM processes; for example, if changes to local government finance and competencies are required, it may be necessary to change the laws dealing with ministries and their competencies. It is important to ensure that the laws and implementing regulations are well integrated.
 - Policies and procedures for implementing these laws should be developed, adopted, and put in place.
 - Ensure that processes used to develop primary legislation are inclusive and iterative, with participation by civil society and other stakeholders as appropriate.
 - Public comments should be solicited through public hearings or media- and internet or phone processes, including at sub-national level.
 - Legislation should include an outline and timeline for implementation of new provisions and strategic plans.
- b. **Budget Planning and Development:** A basic budget planning, development, and appropriations system may need to be developed and/or implemented more completely or effectively. If there are difficulties in current systems' implementation, the reasons should be identified so that capacity development measures can be taken to improve performance to good practice levels.
 - Development of strategic plans and establishment and capacity development for macroeconomic units and forecasting functions should be addressed for effective budget planning. Assistance in the development of sector strategies may be needed, particularly in sectors that are the focus of donor assistance. Both economic and fiscal forecasting are necessary for effective budget planning.
 - Simple tools and/or systems may be helpful in the core phase as well as facilitation of processes and transitions.
 - A PFM strategic plan as referenced above should be developed for implementation of reforms with timelines, goals, milestones for progress, and performance indicators.
 - A simple line item budget development and appropriations system should limit expenditures by institutions or levels of government to the available revenues projected by conservative macroeconomic and fiscal forecasts should be implemented and operate effectively.
 - Appropriations should be disaggregated to the economic category level, with further detail to the item of expenditure level generated by budgeting organizations in more detailed justifications. The primary economic categories are wages and salaries; goods and services; grants, subsidies and transfers, and debt service payments; while line items are specific and detailed expenditures such as wages, travel, fuel, etc.
 - A unit within the legislature or an external, nonpartisan agency reporting to the legislature should be in place to support review and analysis of budgets and fiscal affairs.
- c. **Transactions and Budget Execution:** The basic budget execution and accounting systems should be operational and effective by the end of this phase, including treasury and internal control functions. If such systems are already in place but there are difficulties with implementation a combination of capacity development, technical assistance, and the provision of practical tools can be used to improve performance to satisfactory levels. Improved capacity may be needed in the following areas:
 - Accounting systems and staff should be able to do rigorous cash basis accounting and establish and maintain basic internal controls.

- A system of classification of revenues, expenditures, and budgets with room for expansion into functional classifications should be developed and implemented that is compatible with COFOG and GFS standards.
 - Development and specification of an Integrated Financial Management Information System (IFMIS) linked to the classification and accounting systems. There are various commercially available IFMIS products (Free Balance, SAP, Oracle, etc.), but partner country staff should receive training on customization of the software.
 - Appropriated funds should be allocated efficiently and transparently in accordance with treasury regulations.
 - Annual cash flow plans should be developed with the cooperation of budget organizations and the MOF. These plans should govern the periodicity and fund allocations to institutional accounts for expenditures.
 - Measures should ensure effective cash management and handling of cash on hand, although the use of short-term credit facilities may be deferred until an agreed date or state of PFM system development.
 - A Treasury Single Account or limitations on the number of government bank accounts should be in place.
 - Ensure proper monitoring and reporting of revenues and expenditures at the organizational and economic category levels consistent with laws, rules, and regulations through the introduction of simple measures. Reports should be made public through the internet and public media.
- d. **Revenue Systems:** Revenue mobilization systems should function effectively and efficiently for all types of public revenues. The forthcoming USAID Guide to Revenue Mobilization will provide extensive guidance on these topics.⁵⁸ However, here is some general guidance for the “Core Systems” phase:
- After adoption of revised laws, rules, and regulations, the first priority is capacity development and reorganization of revenue offices on a functional basis.
 - Priorities for reforms should be based on the potential size of revenue sources. If the largest source of revenues is customs fees and taxes collected at the borders, customs reform should be given the highest priority. In tax revenue administration, the highest priority should be enhancing collections from the highest income taxpayers, who are often able to contribute more than 80% of total tax revenues. Early increases in revenue mobilization can stimulate further reforms.
 - Some countries will need technical assistance on the adoption and implementation of computerized revenue systems. In designing these computerized systems, ensure they will work well with planned future fiscal IT systems.
- e. **Public Administration:** This broad category includes human resources, anti-corruption, contracts, management structures, and procurement. Although some aspects of these capacities are not directly related to public financial management, they can have substantial impact on PFM reforms. A forthcoming USAID Guide to Public Administration Reforms offers additional guidance in these areas.⁵⁹ Some general considerations for public administration are listed below.

⁵⁸ Forthcoming from USAID Bureau of Economic Growth, Education and the Environment, Office of Economic Policy, 2014.

⁵⁹ Forthcoming from USAID Democracy, Human Rights, and Governance Center of Excellence, 2014.

- Human resource systems should include merit-based recruitment and retention systems, performance reviews, position controls, and rigorous reporting requirements. Civil service reforms can be gradually phased in. . HR systems play a vital role in fostering capacity development of personnel for PFM reforms. Staff capabilities can be increased through training, education programs, or on-the-job approaches such as mentoring, shadowing, secondments, study tours and exchanges. Classroom training is often not the most effective method.
 - An automated or semi-automated personnel and payroll system is very important. There should be a system for verification of employment, timesheets and payments. Electronic payment of salaries and wages for public employees can help to reduce waste, fraud, and abuse.
 - Rigorous accounting and cash management rules and procedures also reduce the potential for unjustified payments and waste. Sound anti-corruption strategies should be instituted, including feasible means for prosecution, adjudication and sanctions as well as the establishment of dedicated anti-corruption institutions.
 - Management structures and organization should be rigorously controlled. The ability of institutions to change their structure, organization, and number of positions should be subject to review and approval by bodies competent for those purposes. Responsibility for structures and functions should rest at the institutional level with oversight by human resource and bodies with overall budgetary responsibilities (e.g., MOF), and be subject to governmental or legislative approvals or confirmations. The addition of functional considerations to these controls will be of assistance for the introduction of program budgeting in the following phase.
 - Any necessary changes in procurement legislation should be sought. Consistent with existing law, systems should be in place to control procurements, as well as contract management and reporting systems. Initially, partner countries should concentrate on ensuring that the legislated controls and processes are fully implemented. Initial steps should include capacity development and the establishment or upgrading of an appeals body and complaint systems.
- f. **Auditing:** Core auditing entities should be in place for internal and external audits. Government agencies should have an internal audit unit that reports to management. A Supreme Audit Institution should report to the legislature. Capacity development should emphasize financial and compliance audits. Annual audit plans should be adopted. Laws or regulations should ensure the transparency of external audit reports.
- g. **Business Enabling Environment:** Parallel reforms to improve the enabling environment for creation and growth of businesses may be needed. Support for non-inflationary macroeconomic growth can complement PFM reforms by increasing fiscal revenue mobilization and equity.
4. **Practice Enhancement Phase:** The practice enhancement phase builds on the progress and systems of the core systems phase and focuses adoption and implementation of international good practices. Experience has shown that it may take 3 to 10 years to fully execute these changes. The time needed varies greatly with partner country capacity, political will, and available funding from internal and external sources. During the practice enhancement phase, continued progress may be needed in areas discussed in the previous phase, but the following areas will often need to be addressed:
- a. **Legislative Basis:** The legislative basis for improving PFM and governance should be refined and expanded.

- The legal framework for management of central and local government institutions will usually need to be amended Inclusive, iterative processes should continue to be used. In the practice enhancement phase, the role of external technical assistance or facilitation should be reduced if possible to increase local commitment and sustainability.
 - Policies, regulations, and procedures are likely to need updating to include the additional changes contemplated in this phase.
 - Changes in the authorities and competencies or powers of sub-national units should be considered in enabling legislation. Decentralization and/or deconcentration should be considered to bring political and administrative control of services closer to the citizens. Civil society should be encouraged to link more closely with supportive, local governments.
 - Again, legislation should include an outline and timelines for implementation of new provisions that agree with those adopted in strategic plans.
- b. **Budget Planning and Development:** Continued capacity development may still be needed in the areas below:
- Macroeconomic units and economic and fiscal forecasting functions should continue to develop their capacity for budget planning.
 - More complex computerized tools and/or systems can be adopted to improve forecasting, including the cooperative development of econometric models for economic growth and public revenue projections.
 - The PFM strategic plan should be monitored and adjusted if necessary.
 - The Ministry of Finance or budget agency should begin developing and using Medium Term Expenditure Frameworks (MTEF). Initially, a Medium Term Fiscal Framework (MTFF) should be adopted for expenditures down to the sector or function of government level (see Annex 3 for sector and function classifications under the GFS/COFOG model). The macroeconomic forecasting unit should take the lead on the MTFF. After the adoption of program budgeting and one or more budget cycles, transition to a Medium Term Budget Framework (MTBF). The MTBF includes revenues and expenditures as well as sector and program missions, goals, and objectives that can be integrated into the budget development process.
 - Implement multi-year budgeting at the same time as the launch of the MTFF. Projections beyond the current year should be presented as indicative, rather than commitments due to the potential for changes.
 - Begin the adoption of program budgeting by following a multi-stage process. First, budget organizations should divide their budgets by functions and programs. As a second step, performance indicators for programs should be included in MTBF and budget documents. These processes may make changes that require refinements to the initial structure of programs selected.
 - Further improvements to budget processes may be needed, including effective integration of capital budgeting and any Public Investment Program (PIP- projects developing capacities and including capital expenditures, usually donor-funded) including recurrent operating, maintenance, and replacement cost estimates.
 - Budget documents should be made public to encourage involvement of civil society and other stakeholders in the budget cycle, and mechanisms adopted to ensure their ability to participate.
 - Continue to build the capacity of the legislature’s fiscal unit to support review and analysis of budgets and fiscal affairs.
- c. **Transactions and Budget Execution:** Further improvements in budget execution should be considered at this stage, including moving to a modified accruals system. These improvements may include:

- Government accounting system and staff capacities may need to be upgraded before moving to a modified accrual system. It often takes several years of phased implementation to make this transition.
 - The classification system for revenues, expenditures, and budgets implemented in the core systems phase should be expanded to include functional and program-level classifications. The system should be compatible with COFOG and GFS standards and make it easy to produce reports for discussions with international financial institutions.
 - The IFMIS system adopted in the core systems phase should be fully implemented. IT, line budgeting, and MOF staff should gain expertise on system customization processes to ensure utility and sustainability.
 - Periodic allocations of appropriated funds should follow transparent processes governed by treasury regulations. Quarterly allocations are recommended for effective management and service delivery.
 - Robust internal controls should be fully implemented, monitored, and reported.
 - Annual cash flow plans should include procurement plans collaboratively developed by budget organizations and the MOF. The MOF should use the annual cash flow plans to govern allocations.
 - Cash management systems should be fully developed, including Treasury Single Accounts, overnight sweeps of bank accounts, and short-term investment of surplus funds.
 - Monitoring and reporting of revenues and expenditures at the organization, program, and economic category levels should be enhanced and periodic public reporting well established.
- d. **Revenues:** Detailed guidance on revenue systems will be available from the USAID Office of Economic Policy in 2014.⁶⁰ However, the following is general guidance for the Practice Enhancement phase:
- Professional education and capacity development for revenue officers should be continued and deepened, with consideration given to obtaining and maintaining professional or functional certifications.
 - Revenue mobilization reforms in should be expanded to include medium-income taxpayers and additional customs control systems.
 - Introduction of a Value Added Tax (VAT) or other taxes on consumption if often recommended to reduce income tax compliance problems Development and adoption of VAT systems using good practices will take some time and should begin during this phase.
 - User fees and increased collection of non-tax revenues should be emphasized in reforms.
 - Systems for effective appeals and revenue payer audits should be expanded and made more transparent.
- e. **Public Administration:** Further improvements in public administration systems are vital to fully integrate PFM reforms into partner country governance systems. Consider the following additional reforms:
- Deepen civil service reforms Formalize initial and continuing training for PFM staff with extensive cooperation between training institutions and the MOF.
 - The payroll/personnel system should be fully automated and integrated with the IFMIS. Sub-systems for position controls; verification of employment, timesheets, and payments; and electronic payment of public employee should be improved as necessary.

⁶⁰ Forthcoming [USAID Guide to Revenue Mobilization](#) from USAID Bureau of Economic Growth, Education and the Environment, Office of Economic Policy, 2014.

- Expanded support for anti-corruption strategies and organizations becomes increasingly important during this phase, as ways to defeat the new PFM systems are identified known and disseminated. Further mechanisms for increasing transparency, publicity, and surety of sanctions should be implemented. Asset reporting by public officials, strong ethical codes, and post-employment conflict of interest restrictions should be instituted or improved.
 - Institutionalize the processes and functions implemented in the core systems phase for management structures and organization.
 - Introduce verification requirements through compliance audits by internal and external auditors.
 - Ensure a fully functioning public procurement system, including contracts management, appeal, and reporting systems. The system should be fully applied to all procurements above the petty cash level, and checks put in place at multiple levels of government and by auditors should be implemented. Continue capacity development. Promote transparent enforcement of systemic rules and regulations within an automated reporting system linked to the IFMIS.
- f. **Auditing:** As internal and external audit organizations become more capable, there will often be pressure to control their activities. In the practice enhancement phase, the full range of protections to ensure effective audits championed by INTOSAI should be in place, including:
- The Supreme Audit Institution should be independent of the executive branch and report to the legislature.
 - Internal audit units should report to senior management, both within budget organizations and the government as a whole.
 - Safeguards should ensure sufficient resources for the SAI and internal audit units.
 - Formalize safeguards and sanctions for handling and publishing audit findings should be in legislation, rules, and regulations.
 - Perform performance audits in addition to compliance and financial audits.
 - Annual audit plans should be adopted and the transparency of audit results ensured.
- g. **Business Enabling Environment:** Extensive adaptation of systems in the business enabling environment, enterprise governance, and most other sectors of government operations will be needed to ensure integration of changes made during the Practice Enhancement Phase, and should proceed as soon as possible.
5. **Institutionalization Phase:** The reforms introduced in the previous two phases will require a period of use to be fully institutionalized. Ensure that the various systems adopted all work together and do not lead to negative incentives or unintended consequences. Vigilant monitoring may be needed to prevent the degradation of systems. Some additional considerations for the institutionalization phase include:
- a. **Legislative Basis:** PFM legislation and related governance considerations should be refined further in the institutionalization phase as needs become apparent.
- The ability to monitor, analyze, and develop amendments to laws and regulations through inclusive, iterative, and collaborative processes should be well established within the partner government, with any external inputs on an invitational basis.
 - Changes in the roles of sub-national units through decentralization or deconcentration will require changes in laws and regulations.
 - The legislation should include an outline and timelines for implementation of new provisions.
- b. **Budget Planning and Development:** In the institutionalization phase, the primary changes needed are likely to be in performance monitoring systems linked to budgetary and program support.

- Macroeconomic units should be fully capable of forecasting and monitoring the economic and fiscal environments using complex computer-based systems.
 - Budget preparation and development should include sufficient inputs from stakeholders, civil society organizations, and citizens.
 - Medium Term Expenditure Frameworks and medium-term budgeting should be fully and consistently implemented, with the addition of performance indicators down to the program or sub-program level, either with or without linkages to performance budgeting. This Medium Term Performance Framework incorporating performance considerations into a Medium Term Budget Framework is the most fully developed form of Medium Term Expenditure Framework.
 - Program budgeting integrating performance indicators should be fully implemented and the budgets prepared through inclusive, iterative processes following the timetables established by law.
 - Capital budgets and/or Public Improvement Programs (PIP) with specific out-year cost estimates should be fully integrated with the annual and medium term budgets presented to decision makers.
 - Budget documents for public consumption should be routinely published and publicized.
 - The legislature’s fiscal unit should be fully operational and able to support analyses of budgets and fiscal affairs by the legislature and its sectoral and fiscal committees.
- c. **Transactions and Budget Execution:** During the institutionalization phase, countries should consider switching from cash to accrual system accounting, which would require changes in operations and reporting.
- Accounting systems and staff capacity will need to be developed to adopt and implement accrual accounting. It may take several years to phase in this change.
 - The MOF should update the classification system to comply with changes in internal and international practices, with controls to ensure changes are correct and necessary.
 - The country’s IFMIS system should be fully operational and managed by the partner country. Additional modules may be purchased or developed for greater functionality.
 - Robust internal controls should be fully implemented and their effects monitored and reported to management. Risk-based systems and computerized solutions may reduce the numbers of transactions that have to be monitored by staff.
 - All agencies should use annual cash flow and procurement plans.
 - Cash management systems should be fully implemented using a Treasury Single Account.
 - Monitoring and reporting of all revenues and expenditures at the organizational, program, and economic category levels should be routine, with quarterly public reporting.
 - Prior year budget results should be published in annual budget submissions.
- d. **Revenues:** Domestic resource mobilization systems should be effective and efficient for all types of revenues and fully implemented.
- Continue developing the capacity of revenue officers, preferably with professional or functional certifications.
 - Reforms in revenue mobilization should be expanded to include small taxpayers and customs systems should follow best practices.
 - A modern VAT system should be fully implemented.

- All functional divisions of revenue systems should be implemented down to the lowest-level offices with effective mobilization of local revenues.
- e. **Public Administration:** The systems and reforms initiated in the previous phases should be in full operation, including professional capacity development systems, payroll/personnel, anti-corruption, management and organizational controls, and procurement. Their performance should be transparent and carefully monitored and to increase support for good governance and PFM.
- f. **Auditing:** Both the Supreme Audit Institution and internal audit functions should be fully operational, with sufficient safeguards. Financial, compliance, and performance audits should be performed, with an emphasis on risk-based selection. Vigilance may be necessary to preserve their independence and effectiveness.

The above phases are only indicative. Some reforms may need to be deferred to a later phase, if the political will to enforce them is not present.

VII.3 Good Practices in Sequencing Reforms

The four approaches to sequencing PFM reforms emphasize the importance of incremental implementation at a pace that partner country institutions can absorb effectively. USAID experience in Kosovo, Afghanistan, Kazakhstan, and many other countries indicates that a graduated and sequential approach to reforming PFM sub-systems is likely to be more effective than attempts to alter many systems or sub-systems simultaneously.⁶¹ However, the absorptive capacity of partner governments varies and those experiences may not be generalizable if sufficient capacity development assistance is provided and the political will exists.

Country ownership of the reform process is essential for effective implementation and sustainability. Ideally, the partner country, rather than donors, should develop a PFM reform strategy and action plan that donors can then support. However, in most situations, PFM reform strategies and programs are developed through discussions among major multilateral and bilateral donors (especially the IMF and World Bank), and the government. In addition to partner government ownership of reform strategies, USAID requires discussions with other stakeholders. The sequencing incorporated in the reform strategies should reflect the country's own priorities and context, including human and institutional capacity, political economy, and stakeholder agreement. The partner government should set a realistic timetable for reforms and be willing to make multi-year commitments to the process.

Diamond (2013) recommended that countries carry out PFM reforms in the following order: 1) put controls in place to ensure financial compliance, 2) establish mechanisms to improve fiscal stability and sustainability, and 3) introduce systems to promote efficiency and effectiveness in service delivery. Attempting to leapfrog this order could jeopardize the success of the reforms.⁶² USAID recommends an integrated phased approach to PFM reforms;

⁶¹ However, note that a too gradual approach may cause reforms to stall. Care should be taken to check assumptions of organizational absorption capacities against actual experience and partner country commitments, while programming to increase those capacities.

⁶² Jack Diamond, *Background Paper 1: Sequencing PFM Reforms*, IMF: 2013, p. 13-14, <[http://www.pefa.org/sites/pefa.org/files/v13Sequencing_PFM_Reforms_Background_Paper_1_\(Jack_Diamond_Jan_2013\)_0.pdf](http://www.pefa.org/sites/pefa.org/files/v13Sequencing_PFM_Reforms_Background_Paper_1_(Jack_Diamond_Jan_2013)_0.pdf)>.

while also recognizing the need to begin developing and implementing some higher-level systems concurrently. Countries should begin preparing for future phases to reduce the risk of delays and decreased commitment for reforms that are more complex or difficult to implement.

In post-conflict societies, Gallagher [2007] proposed a more prescriptive approach to PFM reform sequencing in post-conflict countries (Figure 19), he suggested applying the following priorities in sequencing:

- For revenue mobilizations partner governments should establish business-friendly systems, reduce compliance costs, and curb corrupt behavior of tax officials.
- For expenditures, governments should:
 - Strengthen treasury operations;
 - Improve budget preparation and planning;
 - Develop and approve a public-sector investment budget; and
 - Strengthen budget execution and audit.^{63,64}

⁶³ Mark Gallagher, Building Fiscal Infrastructure in Post Conflict Societies, USAID, 2007, http://pdf.usaid.gov/pdf_docs/PNADK908.pdf

⁶⁴ USAID, A Guide to Economic Growth in Post Conflict Countries, 2009, http://pdf.usaid.gov/pdf_docs/PNADO408.pdf

Figure 19: Sequencing PFM Activities

Item	Urgent	Immediate	Intermediate	Consolidating
Expenditure control	High Intensity	High Intensity	Lower Intensity	Lower Intensity
Receipts management	High Intensity			
Indirect tax control	High Intensity	High Intensity	Lower Intensity	
Direct tax control		High Intensity	High Intensity	
Fiscal capacity policies	Lower Intensity	Lower Intensity	Lower Intensity	Lower Intensity
Economic and fiscal statistics		Lower Intensity	Lower Intensity	Lower Intensity
Reform of tax policy		High Intensity	High Intensity	Lower Intensity
High Intensity	High-level of effort and assistance intensity			
Lower Intensity	Lower level of assistance intensity			
	No assistance during phase			

Regardless of the exact sequencing of PFM activities, it is paramount that the reforms are designed, paced and phased in close coordination with the partner country. A review of Public Expenditure Framework Assessment (PEFA) results over time provides some key lessons on additional factors that affect successful PFM reform:

- Reforms that involve many actors are slower than those with fewer stakeholders;
- Countries often establish new laws, regulations, and plans, but implementation often lags or falls short;
- Significant reform progress can be made in post-conflict countries despite low capacity, continuing insecurity, underdevelopment, and the lack of prior successful experience with independent statehood;
- Reforms are more successful when country-specific challenges are addressed, rather than borrowing reform approaches from other countries; and

- Reforms do not have to be perfect; they just have to be improvements over the status quo. . Reform approaches can be refined during implementation.

VIII. CONCLUSIONS

A strong public financial management system is an essential necessary condition for economic growth and government efficiency and effectiveness. It is a key element in increasing accountability, transparency, and legitimacy in governance. PFM includes the mobilization of revenue, allocation of funds, expenditures, accounting, and monitoring and evaluation. Sound PFM systems are fundamental to the appropriate use of donor assistance and donor agreements to rely increasingly on partner country systems for budget development, execution, and control will make PFM enhancements more urgent. Successful implementation of PFM reforms depends on maintaining a focus on fiscal discipline, allocative efficiency and operational efficiency. To truly embrace PFM reform governments must commit to transparency and accountability to the public and all stakeholders in addition to legal, technical, and capacity enhancements.

PFM processes and outputs are structured around the budget cycle and can help ensure that public expenditures are well planned, executed, recorded, monitored, reported, and evaluated. The planning process should engage key stakeholders in a participatory manner and be realistic in goals, timeframes, resources, and other constraints. The Budget Cycle planning and development processes should start with a macro-economic framework, fiscal framework, and strategic plans that reflect the country's own priorities and economic context. Key aspects of strong budget execution include a transparent and competitive procurement system, expenditure controls that require adherence to the budget, a sound cash management system, and a good accounting a system to record and report on revenues, expenditures, assets, and liabilities. Finally, a robust and comprehensive system of audits, monitoring and evaluation, and reporting are necessary to inform future budgetary and programmatic decisions.

PFM reform initiatives depend on the partner government's interest and ability to take ownership of the reforms, build a strategy, and invest in human and institutional capacity development. Governments should be responsible for setting their own PFM strategies including the sequencing of reforms, implementation schedules, and the financial and human resources required with the support of donors. Reform strategies should not be driven by donors, although informed discussions between donors and the partner country government may influence funding, strategic elements, and the timing of reforms.

The PFM system must be tailored to country-specific contexts; thus strategy, planning, and implementation will differ across and within countries. However, good functional practices in PFM remain important guarantors of fiscal discipline, allocative efficiency and operational efficiency, and USAID should support their adoption and implementation in partner countries. There is no singular formula for PFM reforms that can guarantee success. Nevertheless, better knowledge of existing PFM systems and processes as well as standards and good practices can improve the results.

The introduction of modern, efficient, and effective PFM systems linked to information technology systems through an IFMIS and its subsidiary components can help to improve governance and particularly e-governance by providing timely and verifiable information on fiscal and budgetary performance. Additionally, as such systems' functionalities are enhanced programmatic performance data can be directly linked for budgeting, decision-making, and accountability purposes. If reform programs including IT are properly designed and sequenced partner countries can advance toward both e-governance and good practice PFM systems more rapidly by allowing them to pass over intermediate reforms. The capacities, political will, political economy and capabilities of partner countries are vital to such progress, and the introduction of IT-based PFM systems is unlikely to be sufficient to counter a lack of preparedness, resources, or infrastructure.

An Integrated Phase Approach combining elements of the basics first, platform, and evolutionary approaches should be used to program the sequence of PFM reforms in partner countries. Care should additionally be taken to ensure the severability and sustainability of each incremental reform within phases to ensure incremental and sustainable progress toward good practices in PFM.

Annex 1: Case Study of Kosovo Fiscal Reform⁶⁵

A 1.1 CONTEXT

Following the cessation of hostilities on June 10, 1999, the immediate concern of the United Nations and the broader international community in Kosovo was to establish an institutional structure for political and social stability. Institutions, a legal framework, and systems for public sector organization and management had to be designed and built from scratch.

From the beginning of the reconstruction effort, it was understood that the initial concentration of effort would be on creating a viable public sector underpinned by a credible framework of financial management and governance as a foundation for a new democratic government. Given the virtual absence of a formal domestic economy the public sector would have to be the most important driver of the economy during a loosely defined near future period of at least 3 to 5 years.

The primary objective of USAID programming in Kosovo was to support implementation of policy and institutional reforms required to strengthen the economic recovery and transformation. Activities included technical support and training to promote institutional reforms in fiscal policy, public financial management, financial sector regulation, commercial law, privatization, and public utilities. The donor community worked with the Ministry of Finance and Economy, the Tax Administration of Kosovo, and the Central Bank to develop effective policies to ensure economic, fiscal, and financial stability and enable economic growth.

A 1.2 OVERVIEW OF THE REFORM

During the initial stabilization period, significant donor funding (including USAID support), was dedicated to budget preparation as domestic and international pressures demanded better PFM systems, processes and controls.

The United Nation's Mission in Kosovo (UNMIK) was the initial governmental authority during the reconstruction and stabilization period. It helped establish a basic, centralized budget planning process, which was used for the first full budget cycle in 2000. This basic planning process served as the first step in development of a fiscal and financial structure for the new public sector. With USAID support, this process was refined and expanded to include all MDAs and public enterprises in 2001. Municipalities were included in the planning process even in these early budget cycles. This initial budget was on a commitment basis, with appropriations covering the full cost of multi-year projects. In the early years, from 2000 to 2005, actual

⁶⁵ Adapted from internal documentation developed by Matthew Smith, USAID Growth and Fiscal Stability Initiative Project implemented by Deloitte Consulting.

budget execution results were either balanced or in surplus and unspent commitments were carried forward from one year to the next until a project was finalized.

Capital and recurrent budget planning remained separate in both processes and institutional structures. USAID helped strengthen and expand budget coverage through a systematic public investment planning process and program with the Department of Reconstruction. The first public investment plan was prepared in 2000 and covered the period 2000-2004.

As Kosovo evolved from post-conflict reconstruction to economic development, the capital program planning activities performed by the Department of Reconstruction were transferred to the Budget Directorate of the UNMIK Central Fiscal Authority. This entity was replaced by the new Kosovo-led Ministry of Finance and Economy between 2002 and 2005 to facilitate production of an integrated Kosovo Consolidated Budget, including both capital and recurrent expenditures. The methods and procedures for integrating the capital and recurrent budgets were developed and incorporated in the budget cycle for 2002.

A set of strategic policy directions designed to guide capital and recurrent expenditure policy were developed cooperatively by USAID's Fiscal Reform Program and the Ministry of Finance and Economy and adopted in 2002-2003. The most urgent need identified was for practical efforts concentrated on training and capacity development for senior staff in MDAs, municipalities and public enterprises.

The 2003 budget was a milestone in Kosovo's development. All expenditures of the Provisional Institutions of Local Self-Government (the newly established interim governing body prior to independence, which operated in parallel with UNMIK) were financed entirely from local revenues. Just three years earlier, approximately 80 percent of the budget had been financed by donors. This achievement was facilitated by the USAID-supported introduction of modern tax policies and tax administration together with modern public expenditure mechanisms.

USAID also helped to promote a strategic approach to budget preparation, moving from a single year to a multi-year budget. Budget documents contained one year appropriations and two year forward estimates of the cost of all programs and capital projects. These forward estimates informed rolling budget preparation and planning process as the previous first year of forward estimates became the starting point for each new budget cycle. Budget development focused on specific strategic policy driven changes to those forward estimates; rather than starting each budget from a zero base. Each new budget was transmitted to the legislature as a comprehensive budget proposal that outlined the policy and purpose of each proposed budget appropriation. The detailed proposal built on the policy analysis contained in an MTEF.

At the start of every budget cycle, a detailed comprehensive medium-term fiscal strategy delineating a set of policy priorities agreed by the government had already been prepared. This strategy automatically became the basis for the new budget, which was the instrument for delivering programs to achieve these priorities. The strategy thus governed the first year of the medium-term budget on a rolling basis. A modern treasury system was the financial delivery mechanism for budget execution. The entire process, including the medium-term strategy, policy prioritization, appropriations, budget execution and management and operation of the government's treasury single account is rigorously defined in Kosovo's Law on Public Financial Management and Accountability.

Early efforts to introduce program budgeting were unsuccessful because of the rapidly changing institutional structures and lack of capacity. However, an unintended result of the inability to implement program budgeting was basing of most budgets on incremental changes to line items, rather than programmatic or functional assessments of needs.

At the municipal level, the quality and transparency of municipal budget documents was improved, with a particular focus on multi-year budgets. USAID assistance supported a transition from simple municipal budgeting based on a few budget line items to a comprehensive municipal budget presentation based on annual and multi-year budget plans from 2002 through 2012.⁶⁶ Municipal budgets included a broad range of budget programs associated with local functions, detailed municipal capital programs, and detailed projections of municipal own source revenues. Financing for expenditure plans at the local government level was fully incorporated in the medium-term fiscal framework. To achieve these reforms, USAID assisted the Ministry of Finance and Economy to provide comprehensive training programs for municipal budget organizations and provided direct technical assistance to municipalities from 2002 to 2013.

Initial USAID efforts to support the introduction of a Medium Term Budget Framework in 2003-2003 were unsuccessful due to the combination of a lack of program budgeting inputs, insufficient political will, and limited local capacity to deal with complex processes. A simplified Medium Term Expenditure Framework was developed and implemented based upon generalized sector policy priorities and a Medium Term Fiscal Framework (MTFF), with the first MTEF approved for Fiscal Year 2009. Figure 20 provides a simplified summary of the fiscal results in successive MTEF exercises. Given the development needs of Kosovo's rapidly transforming economy and resulting variations in both projected performance and policy, the sharp fluctuations shown are not surprising. Nevertheless, development of the MTEF improved fiscal discipline across budget organizations and their long wish lists of desired expenditures shortened as the governmental priority process took root.

⁶⁶ The first municipal budgets were constructed on the bases of five budget lines closely aligned to grant financing: general administration, education, primary health care, firefighting services, and the minority communities' office.

Figure 20: MTEF Projections 2005 – 2012

	2005	2006	2007	2008	2009	2010	2011	2012
Revenues								
2006	628	624	618	622				
2007		713	791	758	777	807		
2008			897	866	1014	1076	1111	
2009				942	1094	1111	1109	1133
Expenditures								
2006	674	700	685	685				
2007		636	700	815	812	830		
2008			848	1389	1412	1409	1370	
2009				942	956	1029	1081	1133
Budget Balance								
2006	-46	-76	-67	-63				
2007		77	91	-57	-35	-23		
2008			48	-523	-398	-334	-259	
2009				0	-138	-82	-28	0

Throughout the first seven years of the institutional and capacity development process, 2000-2007, economic policy considerations were not a priority for the Kosovar-led Provisional Institutions of Local Self-Government. Issues associated with public expenditure and tax policies, appropriate fiscal balances, and trade policy rarely appeared on the weekly government agenda. These competencies were reserved powers controlled by the Economic and Fiscal Council of UNMIK's Pillar IV with inputs from the IMF, World Bank and other donors. To address this situation and a perceived lack of local capacity, USAID assisted the creation of a Macroeconomic Policy Department within the Ministry of Finance and Economy between 2000 and 2010. The Department was staffed with qualified people with the necessary skills to undertake economic analysis.

A 1.3 RESULTS AND LESSONS LEARNED

From capacity development and a financial efficiency standpoint, Kosovo now has a strong financial management system that compares favorably with any country in the Balkans and the central European region. First and foremost, PFM reforms would not have been successful without the support of

international donors and the concrete plan for Kosovar succession they developed. By design, government and stakeholders were engaged from the initial phases of PFM implementation and it was recognized that institutional growth and stability would only be sustainable with Government of Kosovo and stakeholder buy-in and commitment. The commitment and expertise of implementing partners in both delivering technical assistance and PFM reform plan development was instrumental to this success.

USAID support evolved from performing governmental functions to collaboration with Kosovar staff and institutions over the 10-year period from 1999. USAID's emphasis on working with Kosovar counterparts as colleagues enabled effective knowledge transfers. USAID support was also characterized by co-location of technical advisors in partner MDAs and these methods of assistance delivery were the foundations of successful reform. While expatriate advisors initially performed many functions, there was an intensive focus on transitioning these functions to Kosovar staff. This approach facilitated the identification of champions and many of the best performers later occupied senior positions in the Ministry of Finance and Economy.

The success in building and institutionalizing a good practice budget process was closely related to parallel successes in treasury and financial management as well as in the development of macroeconomic policy analysis in the Ministry of Finance and Economy. The high performance and functionality of Kosovo's PFM system enhanced the credibility and integrity of budget and treasury operations following the Law on Public Financial Management and Accountability. This legislation, developed with USAID support is one of the most important laws in Kosovo. Its influence ranged from financial management, budget preparation and execution, the economic policy framework and bearing on both procurement and audit, has acted as a major control on decision-makers' actions in government at all levels.

Over an 8-year period Kosovo was able to transition from an annual budget to an MTEF facilitating the priorities for use of public funds. Fiscal discipline across the Kosovar government and MDAs has increased significantly with MTEF implementation experience.

The strengthened budget process is supported by the Macroeconomic Policy Department, which is now able to:

- Deliver a small macro model based economic projection for the budget
- Deliver regular tax revenue projections
- Provide economic analysis of the effects of economic policy changes and proposals
- Cost public expenditure proposals
- Provide short-term briefings on the economy as required

These new budgeting processes are complemented by significant reforms in budget execution, such as the introduction of an Integrated Financial Management Information System and a Treasury Single Account as well as the adoption of a very strong legal framework which clearly defines the parameters of the PFM system. As a result of these well-coordinated and sequenced reforms, Kosovo arguably now has a leading practice PFM system.

Annex 2: Case Study of Establishing PFM Systems for a New Country: The South Sudan Example

A 2.1 CONTEXT

The Comprehensive Peace Agreement (CPA) of 2005 ended Africa's longest civil war by paving the way for South Sudan's eventual independence from Sudan. In 2006, South Sudan had virtually no transportation or water supply infrastructure throughout the country. It also had no formal institutions, effective rule of law, or even accepted legitimacy within its own society. Consequently, South Sudan had to build its institutions from scratch. In response to the CPA, many donors began strengthening the institutional and human capacity of South Sudan to prepare for the formal independence in 2011.

As a nascent country without a history of formal institutions, effective rule of law or administration accepted as legitimate by its society, South Sudan had to create all its institutions. Donors helped develop administrative and governance structures, and mechanisms for political representation. Donors assisted the Government of South Sudan to create tools and systems to manage public resources in the face of increasing public expectations.

At the time of the CPA, South Sudan had poor public financial management practices and weak institutional capacity. The Government lacked budget credibility and expenditure controls and had poor financial reporting. The lack of financial controls and procedures were manifested in the following issues:

- MDAs received petty cash advances for small purchases without having to report on the use of the funds prior to replenishment. Therefore, there were no accounting records for expenditures made from petty cash and no tracking against the budget.
- The Ministry of Finance and Economic Planning (MOFEP) made large payments directly to vendors at the request of MDAs. However, in the absence of a financial management information system (FMIS), there was no accurate financial record of these expenditures and extremely loose tracking and accounting against the budget.
- MDAs that collected revenue spent them without reporting on the revenues, the uses of the funds or budgeting for them. There was a massive unaccounted for gap in government finances, and a significant portion of revenue and the subsequent expenditures were off-budget.
- Due to cash rationing, MDAs were unable to fully execute their budgets and made no formal priorities for payments. Instead, payments were largely made based on personal connections with senior management at MOFEP. There was no incentive to manage to a budget plan. A pervasive "hurry up and spend" mentality characterized public expenditures.

A 2.2 OVERVIEW OF THE REFORMS

In 2006, USAID began a comprehensive economic governance program to help establish the core institutions, policies, laws and operating processes for a functioning PFM system in South Sudan.

To overcome these challenges, USAID worked with MOFEP to institute reforms that 1) introduced a centralized payment system, 2) established f a FMIS and 3) revamped the petty cash system.⁶⁷

Centralized Payment System

USAID supported the adoption of a centralized payment system in which all MDAs are required to submit requests for payments and supporting documentation to MOFEP for payments to the vendors. A process for submission and approval of payment requests was established. Forms had to be designed and f new units within MOFEP created for logging expenditures, checking the availability of budgeted funds, and payment approvals and processing. USAID provided extensive training for MOFEP and MDA staff to understand their roles and responsibilities and the requirements under the new process.

TABLE 7: Payment Process Reforms in South Sudan

While these steps may seem human and institutional factors. staffing levels had not been military veterans without the infrastructure in MOFEP was and computers. The Treasury throughout the Ministry and difficult. There was also no system receipt of payment requests and MOFEP. Consequently, payment different people and were wrong person or department. While MOFEP and its physical hindered by these challenges.

<p>The process for issuing a payment was redesigned with the following steps:</p> <ol style="list-style-type: none"> 1. Payment Requests from MDAs received <i>Clerical Section</i> 2. Payment Request checked against Budget <i>Analyst</i> 3. Payment request verified <i>Treasury Officer</i> 4. Payment Request Approved Cash Availability checked <i>Director General of Finance</i> 5. Request & Approvals verified <i>Director & Director Accounts</i> 6. Payment instrument prepared <i>Cheques section (for operating & capital) Salary section (for salaries). Recorded in ledger book for each account</i> 7. Confirmation of payment sent to MDA Payments recorded in Ledger <i>Directorate of Accounts Adjustments Section</i>

straightforward, they were complicated by South Sudan had no real civil service, rationalized and many MOFEP staff were qualifications needed. The physical insufficient, with limited space, chairs, desks Department was physically dispersed implementing efficient work flows was for formally receiving and logging the MDA representatives had free access to requests were submitted to a variety of frequently misplaced or diverted to the progress was made in a reorganization of infrastructure, the Ministry continues to be

Introduction of an FMIS

USAID supported the implementation of an FMIS to capture all revenue and expenditures and improve budget execution performance. Initially, only the core treasury module was implemented beginning in 2005. However, its usage was fairly limited at the outset because MOFEP failed to use the commitment controls and only entered a subset of expenditures into the system. Commitments were frequently not cancelled, leading regularly to f

⁶⁷ It should be noted that USAID is also providing assistance to improve the budget planning and preparation process, but these reforms are not addressed in this case study.

double counting of expenses against an MDA's budget. These issues resulted in poor cash management and a continued inability to produce comprehensive financial reports reflecting all revenues and expenditures.

USAID funded extensive training for MOFEP staff, increasing the demand for better reporting and delineation of roles and responsibilities, and production of payment instruments (checks and electronic fund transfers) through the financial management system. Initially, political will for implementation of these reforms was weak, in part because there was a well-entrenched patronage system operated by senior government officials. This system used the flexibility possible under South Sudan's weak budgetary controls to preferentially set priorities for payments.

Over time, MOFEP's senior leadership had increasingly supported reforms, although timely payment of expenditures and enforcement of budget compliance posed ongoing challenges. Although the system was activated to generate payment instruments, the majority of payments are still generated manually, which allows payments to be made outside of the system. Developing sufficient capacity within MOFEP for use and maintenance of the system has been gradual, and by 2012 MOFEP was still heavily dependent on USAID support. Additionally, MOFEP was slow to enforce the use of budget controls and allowed MDAs to spend beyond the allocated budget for both specific line items and the budget as a whole, weakening the effectiveness of the FMIS. MOFEP and the MDAs have been slow to use the FMIS to generate reports that can help them manage public finances. Additional training is needed to assist MOFEP budget analysts understand how monthly budget expenditure reports can be used to help MDAs adhere to their budgets and improve their efficiency in the use of funds.

Revolving Petty Cash Fund

MDAs received petty cash allocations for small expenditures such as coffee, small office supplies, and transportation. The amount of petty cash provided to each MDA varied based on the size of the agency's budget. After an MDA exhausted these funds, they asked for replenishment from MOFEP. Previously, MOFEP provided the petty cash replenishment without requiring any accounting or reconciliation of how the funds had been spent, so they did not capture the expenses in the general ledger. A significant percentage of each MDA's budget was spent through petty cash, but MOFEP lacked accurate financial records on how the money was spent.

After introduction of the FMIS, MOFEP changed its petty cash system to require that each MDA submit a complete accounting of how petty cash was spent, substantiated by receipts, prior to receiving replenishment. This allowed expenditures to be accurately recorded according to the COA and entered in the FMIS so they could be captured in the financial data. To implement this reform, USAID trained multiple financial officials from each of the MDAs and created a new Petty Cash Acquittal Form. USAID also helped MOFEP establish a process, similar to the process for centralized payments, to review and enter petty cash expenditures in FMIS and approve the replenishment within MOFEP's Treasury Department.

Despite achieving these milestones, helping MDAs understand the required back-up documentation and determining the right funding level for each MDA continued to be a challenge. Moreover, as the system is still fairly new, it appeared that many MDAs were not able to fully account, or reconcile, their petty cash funds, and slowly drew down the amount of cash available with successively smaller and more frequent replenishments.

A 2.3 RESULTS AND LESSONS LEARNED

While these reforms are listed separately above, they were all interlinked and mutually dependent upon each other's success. Collectively, these reforms had a significant impact on MOFEP's ability to monitor public expenditure and report on public finances. While still not fully operable, these reforms allowed MOFEP by 2012 to capture over 90% of expenditures in FMIS and produce more meaningful and comprehensive financial reports. As a result of the improved reporting, MOFEP and the MDAs are beginning to manage budgets by analyzing budget execution data and making spending decisions accordingly. While substantial progress is still needed, these reforms will facilitate the development of more credible budgets as MOFEP and MDAs have more reliable data about how they have spent previous year's allocations and how spending reflects national priorities.

To provide a framework for improved governance, the government enacted in December 2011 a new Public Financial Management and Accountability Act that set out the provisions for budget preparation and execution, treasury and debt management, reporting requirements, and the role of the Audit Authority. It also sets out the framework for transfer of budgetary funds to the ten states of South Sudan. However, progress had been slow toward implementation of many provisions of the Act during the period of financial crisis for the Government of South Sudan that began with a protracted shutdown of oil exports in January 2012 and extreme civil conflicts that erupted in late 2013.

In implementing these reforms during 2006-13, several key lessons were learned:

1. Buy-in from senior and middle management is essential. While MOFEP leadership consistently and verbally supported the reforms, at times their actions did not correspond to those commitments. Vested interests sought to maintain the status quo and many did not fully understand the importance, inter-linkage and impact of the reforms.
2. Capacity issues require significant effort and dedicated training. Any reform approach should emphasize sustainability such that when donor support decreases, the counterpart is able to assume each of the functions.
3. Seemingly small issues, such as the lack of desks and chairs, can have a significant impact on the success of a reform.
4. Successful implementation of PFM reforms requires attention to detail. Use of the FMIS and the introduction of the centralized payment system struggled until very detailed manuals and forms were developed -- providing a step by step guide to the new processes. These detailed manuals also helped support sustainability.
5. Support must be provided to MDAs, as well as MOF, to obtain their buy-in and understanding of the reform.

Despite the reforms over this period, budget credibility remained a critical weakness, with total government and MDA expenditures frequently exceeding the approved budgets. While a foundation had been laid to allow MOFEP and the MDAs to begin improving the budget process with the more comprehensive data that had become available, further needs remained for both donor support and for improved quality of governance by political authorities.

Annex 3: COFOG and GFS Category Groups and Functions

The following listing of classifications of expenditures by function and economic category, and revenues by classification follows the IMF's Government Financial Statistics (GFS) format as well as the OECD/UN Classification of the Functions of Government (COFOG) system. Further information on the classes that compose each group is available as a separate document. "N.e.c." is not elsewhere classified.

7 Classification of EXPENDITURES by Function (GFS/COFOG)

701 General Public Services

- 7011 Executive and legislative organs, financial and fiscal affairs, external affairs
- 7012 Foreign economic aid
- 7013 General services
- 7014 Basic research
- 7015 R&D1 General public services
- 7016 General public services n.e.c.2
- 7017 Public debt transactions
- 7018 Transfers of a general character between different levels of government

702 Defense

- 7021 Military defense
- 7022 Civil defense
- 7023 Foreign military aid
- 7024 R&D Defense
- 7025 Defense n.e.c.

703 Public Order and Safety

- 7031 Police services
- 7032 Fire protection services
- 7033 Law courts
- 7034 Prisons
- 7035 R&D Public order and safety

7036 Public order and safety n.e.c.

704 Economic Affairs

7041 General economic, commercial, and labor affairs
7042 Agriculture, forestry, fishing, and hunting
7043 Fuel and energy
7044 Mining, manufacturing, and construction
7045 Transport
7046 Communication
7047 Other industries
7048 R&D Economic affairs
7049 Economic affairs n.e.c.

705 Environmental Protection

7051 Waste management
7052 Waste water management
7053 Pollution abatement
7054 Protection of biodiversity and landscape
7055 R&D Environmental protection
7056 Environmental protection n.e.c.

706 Housing and Community Amenities

7061 Housing development
7062 Community development
7063 Water supply
7064 Street lighting
7065 R&D Housing and community amenities
7066 Housing and community amenities n.e.c.

707 Health

7071 Medical products, appliances, and equipment
7072 Outpatient services
7073 Hospital services
7074 Public health services

7075 R&D Health
7076 Health n.e.c.

708 Recreation, Culture, and Religion

7081 Recreational and sporting services
7082 Cultural services
7083 Broadcasting and publishing services
7084 Religious and other community services
7085 R&D Recreation, culture, and religion
7086 Recreation, culture, and religion n.e.c.

709 Education

7091 Pre-primary and primary education
7092 Secondary education
7093 Postsecondary non-tertiary education
7094 Tertiary education
7095 Education not definable by level
7096 Subsidiary services to education
7097 R&D Education
7098 Education n.e.c.

710 Social Protection

7101 Sickness and disability
7102 Old age
7103 Survivors
7104 Family and children
7105 Unemployment
7106 Housing
7107 Social exclusion n.e.c.
7108 R&D Social protection
7109 Social protection n.e.c.

“The Classification of the Functions of Government (COFOG) was developed by the Organization for Economic Co-operation and Development and published by the United Nations Statistical Division. It can be applied to government expense and the net acquisition of nonfinancial assets. COFOG has three levels of detail: Divisions, Groups, and Classes.”

The Divisions could be seen as the broad objectives of government, while the Groups and Classes detail the means by which these broad objectives are achieved. For further information on COFOG, see Classifications of Expenditure According to Purpose (United Nations, Department of Economic and Social Affairs, Statistics Division, Statistical Papers, Series M, No. 84, New York, 2000).

The initials “CS” or “IS” follow the title of each Class in parentheses to indicate whether the services produced by general government units and included in this Class are collective or individual services. This distinction is used for the computation of final consumption expenditure and actual final consumption in the national accounts, as described in Appendix 3. The classification numbers have been modified slightly to conform to the coding system of this manual. The numeral “7” is prefixed to all codes and the punctuation separating Divisions, Groups, and Classes are deleted.”⁶⁸

⁶⁸ *Government Finance Statistics Manual, Annex 6; IMF, 2001.*

Classification of Expenses/Expenditures by Economic Category (GFS/COFOG)

21 Compensation of employees [GFS]

211 Wages and salaries [GFS]

2111 Wages and salaries in cash [GFS]

2112 Wages and salaries in kind [GFS]

212 Social contributions [GFS]

2121 Actual social contributions [GFS]

2122 Imputed social contributions [GFS]

22 Use of goods and services

23 Consumption of fixed capital [GFS]

24 Interest [GFS]

241 To nonresidents

242 To residents other than general government

243 To other general government units

25 Subsidies

251 To public corporations

2511 To nonfinancial public corporations

2512 To financial public corporations

252 To private enterprises

2521 To nonfinancial private enterprises

2522 To financial private enterprises

26 Grants

261 To foreign governments

2611 Current

2612 Capital

262 To international organizations

2621 Current

2622 Capital

263 To other general government units

2631 Current

2632 Capital

27 Social Benefits [GFS]

271 Social security benefits

2711 Social security benefits in cash

2712 Social security benefits in kind

272 Social assistance benefits

2721 Social assistance benefits in cash

2722 Social assistance benefits in kind [GFS]

273 Employer social benefits

2731 Employer social benefits in cash

2732 Employer social benefits in kind

28 Other Expense

281 Property expense other than interest

2811 Dividends (public corporations only)

2812 Withdrawals from income of quasi-corporations
(public corporations only)

2813 Property expense attributed to insurance
policyholders [GFS]

2814 Rent

282 Miscellaneous other expense

2821 Current

2822 Capital

Classification of Revenues (GFS/COFOG)

11 Taxes

111 Taxes on income, profits, and capital gains

- 1111 Payable by individuals
- 1112 Payable by corporations and other enterprises
- 1113 Unallocable

112 Taxes on payroll and workforce

113 Taxes on property

- 1131 Recurrent taxes on immovable property
- 1132 Recurrent taxes on net wealth
- 1133 Estate, inheritance, and gift taxes
- 1134 Taxes on financial and capital transactions
- 1135 Other nonrecurrent taxes on property
- 1136 Other recurrent taxes on property

114 Taxes on goods and services

- 1141 General taxes on goods and services
 - 11411 Value-added taxes
 - 11412 Sales taxes
 - 11413 Turnover and other general taxes on goods and services
- 1142 Excises
- 1143 Profits of fiscal monopolies
- 1144 Taxes on specific services
- 1145 Taxes on use of goods and on permission to use goods or perform activities
 - 11451 Motor vehicle taxes
 - 11452 Other taxes on use of goods and on permission to use goods or perform activities
- 1146 Other taxes on goods and services

115 Taxes on international trade and transactions

- 1151 Customs and other import duties
- 1152 Taxes on exports
- 1153 Profits of export or import monopolies
- 1154 Exchange profits

- 1155 Exchange taxes
- 1156 Other taxes on international trade and transactions

116 Other taxes

- 1161 Payable solely by business
- 1162 Payable by other than business or unidentifiable

12 Social contributions [GFS]

121 Social security contributions

- 1211 Employee contributions
- 1212 Employer contributions
- 1213 Self-employed or non-employed contributions
- 1214 Unallocable contributions

122 Other social contributions

- 1221 Employee contributions
- 1222 Employer contributions
- 1223 Imputed contributions

13 Grants

131 From foreign governments

- 1311 Current
- 1312 Capital

132 From international organizations

- 1321 Current
- 1322 Capital

133 From other general government units

- 1331 Current
- 1332 Capital

14 Other Revenue

141 Property income [GFS]

- 1411 Interest [GFS]
- 1412 Dividends
- 1413 Withdrawals from income of quasi-corporations
- 1414 Property income attributed to insurance policyholders

- 1415 Rent
- 142 Sales of goods and services**
 - 1421 Sales by market establishments
 - 1422 Administrative fees
 - 1423 Incidental sales by nonmarket establishments
 - 1424 Imputed sales of goods and services
- 143 Fines, penalties, and forfeits**
- 144 Voluntary transfers other than grants**
 - 1441 Current
 - 1442 Capital
- 145 Miscellaneous and unidentified revenue**

COFOG was produced by the Organization for Economic Co-operation and Development and was published together with the other three classifications in United Nations, *Classifications of Expenditure According to Purpose* (New York, 2000). Material in these sections was adapted from that publication.

Annex 4: Developing PFM Indicators

USAID prepared this guidance on developing indicators for public financial management (PFM). The guidance includes requirements and good practices for measuring the performance and characteristics of PFM systems’:

1. Selecting appropriate indicators,
2. Collecting baselines,
3. Setting targets, and
4. Ensuring data quality for reported results.

This annex supplements, but does not replace or modify the guidance on the Public Financial Management Risk Assessment Framework (PFMRAF). It is focused on developing Performance Monitoring Plans (PMP) for programming in accordance with ADS Chapter 203.

USAID will supplement ongoing trainings to cover performance monitoring for PFM. USAID’s Policy Planning and Learning Bureau developed a workshop on performance monitoring in the spring of 2013. This workshop is now being combined with existing training on evaluation and incorporated into a comprehensive training program that will be delivered beginning in the summer of 2015.

4.1 INTRODUCTION

USAID has developed the following guidance for monitoring of Public Financial Management (PFM) programming. USAID has an articulated system of monitoring and evaluation to measure changes and the performance of development interventions at the program, project, and activity levels. USAID’s guidance on monitoring and evaluation in ADS 203 applies to all USAID operations; it is not specific to PFM or Government-to-Government (G2G) programming. The Performance Management Plan Toolkit contains further resources on selecting indicators, determining data collection methods, and setting baselines and targets. The PPL/LER Discussion Note on Considerations for Monitoring and Evaluation of G2G Activities has additional information on negotiating and planning monitoring and evaluation efforts with governmental partners. Both the Performance Management Plan Toolkit and the PPL/LER Discussion Note on Considerations for Monitoring and Evaluation of G2G Activities are available on Program Net.

Throughout this guidance document, relevant sections from USAID’s Administrative Directives Series (ADS) 203, “Assessing and Learning” are noted, followed by commentary directed toward applying each section to measuring performance for PFM-related activities.

4.2 USAID PFM MONITORING AND REPORTING

PFM-related programming, when implemented as separate projects are often categorized as contributing to “Standard Foreign Assistance” indicators 4.1, 2.2, or 2.4. These indicators are reported annually in the Performance Plan and Report (PPR). Other indicators are not currently reported or tracked at an aggregated level by USAID, but the use of customized indicators is encouraged in project M&E plans. PFM support is usually implemented in activities or sub-activities of projects with a specific non-PFM development or sectoral focus. Indicators for these activities are reported by implementers and appear in annual mission and/or project Performance Management Plans (PMPs), but are not rolled up in USAID or Department of State systems, or reports such as FACTS Info. However, a simplified reporting system is under development, and will be available during 2015. The system will include PFM indicators so that USAID mission support for PFM system enhancements can be recorded and recognized.

Data reported by and to Bureaus and Missions should be obtained from the most recent sources available, including Public Expenditure and Financial Accountability (PEFA) reports, USAID PFMRAF, project reports, and any other available assessments.

USAID recognizes the importance of tracking progress in enhancing PFM systems at the operational level even though it has not tracked changes in country PFM centrally, outside of subsequent PFMRAF assessments. The recommended performance indicators in this Annex are often used by other actors in the international development community. They are the first element in linking USAID PFM indicators to broader international indicators.

4.3 SELECTING INDICATORS FOR PFM PROGRAMMING

USAID is committed to measuring PFM performance, encompassing the sustainability of reforms and their impacts on governance, service delivery, and the performance of functions by partner countries, as well as the efficiency and effectiveness of their PFM systems. Indicator selection is a function of operating units at the Bureau and Mission levels. Monitoring and Evaluation Plans should include indicators measuring the effects of the PFM activities whenever a project or activity includes PFM-support whether or not it is the primary purpose of the project or activity.

The development of indicators for projects and activities is not a function of USAID Washington, but rather of the developing, procuring, and implementing units at the Bureau and Mission levels. This annex lists 38 recommended indicators designed to measure changes in the status of important subsets of a partner country’s PFM system. The indicators are subdivided into 12 areas of interest or indicator categories; reflecting major functions performed by PFM systems. Missions, Bureaus, and implementing partners (including governmental partners) can select functionally indicators from this list in designing project Performance Monitoring Plans (PMP).

The PFM indicators are generally aimed at the Intermediate Results (IR) level and are directed toward high-level evaluation of government PFM systems. They are designed for monitoring or evaluation of changes in those systems, which are often not the focus or are only a partial focus in a project or activity. Changes to PFM systems are also most properly attributable to partner country governments because they carry out their own internal efforts and may receive capacity development support from multiple donors. Moreover, USAID support for PFM is highly dependent on the adoption and implementation of systemic enhancements by the partner. As a result, it will often be impossible to attribute the improvements solely to USAID assistance. As a result, reports should only state that USAID support contributed to these changes.

4.3.1 Application of ADS 203.3.6 to PFM-related Activities: Selecting Indicators

Selection of indicators for PFM- activities is governed by ADS 203.3.6, Standards and Criteria for Performance Monitoring and Reporting. In some situations it may be difficult to determine which indicators to use and report, particularly when PFM activities are a portion of another program, project or activity focusing on other developmental purposes. For example, if a health project includes activities to improve budgeting, accounting, and fiscal administration of public organizations delivery of the health services may be PFM-related, but the principal expected results and indicators are more likely to be concerned with disease treatment rates, caseloads, and other health-related outputs and outcomes. Projects or activities that are mainly concerned with PFM-may be highly complex due to the nature and complexity of the PFM systems of the national or subnational partner government. *Complex* projects dealing with multiple facets of such systems (for instance, dealing with both expenditure considerations and revenues) require indicators that ensure adequate measurement while managing the time and resource burden of data collection. This also highlights a fundamental truth, which is that much, perhaps even most USAID assistance in PFM is highly dependent on the adoption and implementation of systemic enhancements by the partner country no matter which modalities are used for assistance delivery. This in turn highlights the underlying principle that USAID may contribute to changes in PFM but will seldom be able to point to clear or direct attribution. This problem of attribution must be kept in mind and should be noted while monitoring and evaluating assistance activities.

Indicators and data collection and analysis methods and responsibilities should be jointly defined in consultation with partner country counterparts during the design stage and aligned with the partner government's existing reporting systems where possible.

4.3.2 Application of ADS 203.3.7 to PFM-related Activities: Types of Performance Indicators

ADS 203.3.7 lists three types of performance indicator: 1) quantitative and qualitative indicators; 2) index or composite indicators that address complex results by combining two or more data items into a single measure; and 3) the standard F indicators required in the PPR. Indicators may be used to measure inputs, outputs, processes or outcomes of a project or activity focusing on PFM or containing PFM components. In general, the type of indicator selected should be guided by the result it is intended to measure as well as by USAID reporting requirements. The Performance Management Plan (PMP) Toolkit contains further guidance on developing and selecting indicators in Module 2.2, (Select and Refine Performance Indicators) and Annex 7 (the PMP Indicator Criteria Worksheet).

In selecting indicators, it is best to use data sources that are either already collected by the partner country government or that will be collected as a result or output of the provided support. PFM activities generally provide a rich source of data for the use of quantitative indicators because they are often directly linked to policies, processes, and performance of partner country governments. In addition, they can often be disaggregated to the sub-budget organization level and related directly to improvements in PFM performance that can be put into numbers. For example, the impact of the introduction of a real property tax at the sub-national level on organizational performance can be shown through property tax bill amounts; collection and arrears rates; collections unit performance; and appeals received, processed, and successful. All data should be disaggregated by jurisdiction or sub-national unit. This lends itself to accurate and comprehensive use of quantitative indicators.

Enhancing USAID support for improving PFM systems may begin at a higher level of abstraction; for example with changes in policies and governance. In some cases, USAID requires legislative changes as preconditions before support. In these cases, the initial indicators may be primarily qualitative and milestones and rating scales may be most useful. Milestones might start with participation in legislative drafting processes, conferences, or working groups and later include adoption and implementation of new or modified legislation. If the activity is revision of an existing piece of legislation, each milestone should be linked to changes in the current law and the steps in the processes used to develop, review, adopt, and implement those changes. Quantitative indicators may be applicable later in implementation of the supported PFM improvements. When measuring achievements that span such a spectrum, using milestones and/or rating scales that include the range of enhancements is often helpful. It may be particularly useful to use milestones for project performance that begin by measuring outputs like participation in legislative drafting processes, conferences, or working groups and end by measuring specific outcomes such as adoption and implementation of new or modified legislation. For instance, if the activity being measured is revision of an existing piece of legislation, each milestone should be linked to changes in the current law and the steps in the processes used to develop, review, adopt, and implement those changes.

Since some of the expected outcomes of PFM assistance are definitive and the systems are often complex in nature, indexes that combine component indicators can be very useful. The efficiency and effectiveness of PFM systems and the broader functions of partner country governance are both vital to the impact and sustainability of interventions and metrics (whether indicator-based or not) should be included in the Project Monitoring and Evaluation Plan.

4.3.3 Application of ADS 203.3.8 to PFM-related Activities: Gender Issues in Performance Indicators

USAID requires integration of gender issues in the development and selection of performance indicators. Since PFM systems can be important enablers for gender empowerment in partner country economies sex-disaggregated indicators should be included. This applies to tracking inputs (such as the involvement of men and women participating in capacity development initiatives) as well as outputs and outcomes, where applicable.

4.4 COLLECTING AND SETTING BASELINES AND TARGETS FOR PFM INDICATORS

ADS 203.3.9 provides guidance on setting baseline and performance targets. . Accurate baseline data for PFM indicators is critical for setting targets and understanding performance and progress toward the achievement of outputs and outcomes. The often quantitative nature of PFM can provide a rich source of data for this purpose, particularly when partner country data collection and monitoring systems are fully engaged. Module 2.5 of the Performance Management Plan (PMP) Toolkit has further guidance on establishing quantitative and qualitative baselines.

The identification of performance targets for PFM (and G2G more broadly) poses a particular challenge because we are dealing with sovereign governments and their constituent agencies at the national regional, and municipal levels. USAID staff will need to consult with partner governments on their own internal targets and collaborate with them in setting targets where appropriate. Quantitative targets carry the risk of non-performance or underperformance and are affected by external conditions that affect the ability to make desired changes. For example, natural resource revenues may vary with world market conditions outside the manageable interests of the partner country and USAID.

4.4.1 Application of ADS 203.3.9 to PFM-related Activities: Setting Performance Baselines and Targets

In setting performance baselines and targets in PFM, it is best to use information already collected by the partner government or that will be collected through the assistance provided. It is critical to rigorously verify initial data prior to establishing baseline values. Estimated numbers should be avoided if possible because later reporting can show these to be incorrect.

PFM targets should be set in collaboration with government counterparts. Experience shows that planned changes rarely proceed at the anticipated pace and that the constraints to changing and implementing processes are often larger than predicted. Nevertheless, it is important to set targets to encourage reasonable levels of change since it is difficult to achieve anything that has not been requested or mandated. In short, targets should reflect the partner government's commitment and ability and the institutional context for reform. Numerous sources of information and advice can and should be accessed during the target-setting process to avoid over- or under-targeting.

4.5 DATA SOURCES AND VERIFICATION FOR M&E OF PFM SUPPORT

ADS 203.3.6 contains guidance on data sources and verification and ADS 203.3.11 Data Quality, which covers data quality standards and assessments.

4.5.1 Application of ADS 203.3.6 and 203.3.11 to PFM-related Activities: Data Quality and Standards

Data source selection is often critical in monitoring and evaluation of PFM, particularly for quantitative indicators. All data sources and any qualifications or discrepancies should be noted in reporting. For instance, the numbers reported by a line ministry or agency for a type of expenditure might not match those recorded by the Ministry of Finance. While there might be many reasons for conflicting data, such discrepancies can call the validity of performance measures into question.

USAID partner governments must take primary responsibility for data sources and uses, and responsibilities in collaboration with other partners and donors. The ability to build on existing reports and data can be instrumental in ensuring cooperation, better relationships, and accurate reporting, while reducing the data collection burden on partners. When a partner's existing reporting systems are weak, there may be opportunities to incorporate

activities into the project for strengthening partner data collection and reporting systems as a complement to core PFM strengthening approaches. In general, the use of the partner country's central treasury data is preferable for reporting expenditures and revenues, unless dealing with a subnational system with its own separate accounts for revenues or expenditures. This is generally easier if a Treasury Single Account and/or inclusive Integrated Financial Management Information System is in use. If there is reason to believe that the data does not reflect the actual situation, the use of comparators and other verification methods should be done.

If partner government data is unreliable, other data sources can be explored, such as IMF or World Bank data or other donor resources. In any case, verify the methods used to collect the data and their rigor of application.

Similarly, when dealing with non-Treasury data, (such as services provided or persons affected), rely on the partner government's data unless a rigorous assessment has shown it to be unreliable. Where differing authoritative sources of data disagree, carefully document those differences as part of the regular Data Quality Assessment (DQA) process and analyze their effect on the accuracy of the indicator, clearly qualifying any reporting to limit misunderstandings. Ultimately, if the data to be used to measure an indicator are unavailable, that indicator should be dropped after proper documentation.

4.6 SYSTEMIC PFM PERFORMANCE INDICATORS

The indicators presented below are generally directed toward high-level monitoring and evaluation of the characteristics and performance of partner government PFM systems. They are often directed toward measuring accomplishments at the instrumental results (IR)-level. Further Agency-wide collaborative efforts will be directed toward establishing indicators at the project and activity levels as well as for higher-level and institutional effectiveness indicators and measurement tools. The PFM and PPL teams request that USAID staff contribute to these processes and submit additional indicators for future inclusion in this list when requested. These efforts to generate additional indicators will be coordinated with those for indicators in other sectors in an ongoing process.

It is unlikely that any one project or activity will affect all or most of these indicators. In effect, they form a menu for selecting appropriate indicators for use in PMP and program reporting. Indicator use should be dictated by the level and subjects of outcomes established during program and strategy development. If changes in the PFM systems and their major components are expected, a selection can be made from these indicators.

ANNEX 4.6: USAID HIGH LEVEL PFM INDICATORS

Line No.	Indicator Category	Indicator Name	Potential Data Sources	Type of Indicator	Indicator Description	Data Verification Type
1	Macroeconomic Frameworks	Accuracy of revenue forecasting	PEFA PI-3, PFMRAF, Partner Country data, Project PMP	Quantitative Milestone Scale	Actual vs. budgeted revenues in 2 of last 3 years	PEFA Assessment PFMRAF or PMP.
2		Ability to formulate fiscal frameworks	PEFA PI-CFSi, PFMRAF, Project PMP	Qualitative Milestone Scale	3 year medium-term fiscal objectives set at start of budgeting process in last 3 years	PEFA Assessment PFMRAF or PMP
3	Revenue Policy	Fiscal impacts of proposed revenue policy changes are assessed and forecast	PEFA PI-13ii, Project PMP, Partner Country data	Qualitative Milestone Scale	Revenue policy changes significant to government revenues are supported by well-evidenced impact forecasts	PEFA Assessment PFMRAF or PMP
4		Revenues are forecast over the medium term	PEFA PI-13i, Project PMP, Partner Country data	Qualitative Milestone Scale	Revenues are forecast for the medium term including risks	PEFA Assessment PFMRAF or PMP
5	Revenue Administration	Risks to Revenues are Managed	PEFA PI-14ii, Project PMP, Partner Country data	Qualitative Milestone Scale	Partner Country Entities that contribute government revenue use risk management processes	PEFA Assessment PFMRAF or PMP
6		Value of total arrears at FY end as a percentage of revenue	TADAT	Quantitative Milestone Scale	Shows what amount of revenue needs are not immediately collected through taxes	TADAT and ISPMS

7		Percentage of people who paid bribe to tax officials	TI Global Corruption Barometer	Quantitative Milestone Scale	Shows how much of the public believe bribery is part of tax system	TI Global Corruption Barometer and ISPMS
8		Aggregate revenue outturn compared to budget	PEFA	Quantitative Milestone Scale	Shows whether sufficient revenue collected for actual budget needs	PEFA and ISPMS
9		Frequency of complete account reconciliation between tax assessment, collection, arrears and receipts.	PEFA	Quantitative Milestone Scale	How often government attempts to know extent of tax revenue missing	PEFA and ISPMS
10		Audits and fraud investigations are used effectively and outputs are achieved	PEFA PI-14iii, Project PMP, Partner Country data	Qualitative Milestone Scale	Entities that contribute government revenue undertake audits, fraud investigations, and achieve planned outputs	PEFA Assessment PFMRAF or PMP
11	Budget Planning & Preparation	Policy priorities are linked with budgets and finances in a multi-year perspective	PEFA PI-12; PFMRAF; Project PMP	Qualitative Milestone Scale	Medium-term financial frameworks (MTFF), sector strategies, and links between MTFF and budgets are used	PEFA Assessment PFMRAF or PMP. Included in ISPMS?
12		Accuracy and credibility of budgets	PEFA PI-2; PFMRAF; Project PMP; EIP/ISPMS	Quantitative Milestone Scale	Actual variations in expenditures by administrative or functional program, and economic classifications with or w/o legislative approval of contingencies	PEFA Assessment PFMRAF or PMP. Included in ISPMS?
13	Public Accountability in Budget Planning & Preparation	Public Participation in Budget Planning and Preparation Processes	PEFA PI-10, D&G Assessments, PFMRAF, Project PMP	Qualitative Milestone Scale	Extent of participation of non-governmental organizations and citizens in budget planning & preparation	PEFA/DG Assessment PFMRAF or PMP
14		Public disclosure of both budget proposal and enacted budget	Open Budget Index and Tracker	Qualitative Milestone Scale	Are the two fundamental budget formulation documents made public	OBI

15		Budget System and operations are open and transparent	Open Budget Index	Qualitative Index	Numerical and rank score on documents and reporting available to the public	OBI Score
16	Government Cash Management	Extent and frequency of consolidation of government cash balances	PEFA PI-16i, PFMRAF, Project PMP	Qualitative Milestone Scale	Frequency of government consolidations of all cash balances	PEFA Assessment PFMRAF or PMP. ISPMS
17		Extent to which cash flows are forecast and monitored	PEFA PI-16ii, PFMRAF, Project PMP	Qualitative Milestone Scale	Forecasting and monitoring of government cash flows	PEFA Assessment PFMRAF or PMP. Included in ISPMS?
18	Public Sector Accounting & Financial Reporting	Quality of Government Accounting and Reporting Data	PEFA PI-25iii, PFMRAF, Project PMP	Qualitative Milestone Scale	The basis of recording government operations, accounting principles, and national standards applied	PEFA Assessment PFMRAF or PMP
19		Frequency of public release of in-year reports on actual expenditure	OBS and ISPMS	Qualitative Milestone Scale	Offers snapshot of spending throughout year	OBS and ISPMS
20		Timeliness of submission of annual financial statements	PEFA and ISPMS	Qualitative Milestone Scale	Indicates how soon after fiscal year end the financial statement is submitted, and therefore when audit can start	PEFA and ISPMS
21		Debt and expenditure arrears are recorded and reported on	PEFA PI-17, PFMRAF, Project PMP	Qualitative Milestone Scale	Extent of monitoring and reporting on domestic and foreign debt, and expenditure arrears	PEFA/DG Assessment PFMRAF or PMP
22	Procurement	Use of competitive methods in procurement	PEFA PI-19ii, PFMRAF, Project PMP	Quantitative Milestone Scale	Percentage of total value of contracts awarded in most recent FY using competitive methods	PEFA Assessment PFMRAF or PMP

23		Credible reports of not following open and competitive procedures	OBS and ISPMS	Qualitative Milestone Scale	Shows variance from using authorized procurement practice	OBS and ISPMS
24		Indicator of whether gifts or kickbacks needed to award procurement	Enterprise Survey or Quality of Government and ISPMS	Qualitative Milestone Scale	Shows frequency of bribe or corruption entering in procurement	Enterprise Survey or Quality of Government and ISPMS
25		Legal and Regulatory Framework for Procurement is transparent, comprehensive, and mandates competition	PEFA PI-19j, PFMRAF, Project PMP	Quantitative Milestone Scale	Extent to which the legal and regulatory framework meets six requirements set in PEFA	PEFA Assessment PFMRAF or PMP
26		Good practice Procurement transparency and complaints mechanisms are implemented	PEFA PI-19 iii & iv, PFMRAF, Project PMP	Quantitative Milestone Scale	Extent to which procurement information is publicly available and existence and operation of an independent administrative procurement complaints system	PEFA Assessment PFMRAF or PMP
27	Public Accountability in Budget Execution	Public access to key fiscal information	PEFA PI-10, D&G Assessments, PFMRAF, Project PMP	Qualitative Index	Important documents and reports are available to the public without restrictions, requirements to register, or fees including 4 basic info elements and 4 additional elements	PEFA/DG Assessment PFMRAF or PMP
28		Public disclosure of mid-year review	OBS	Qualitative Milestone Scale	Explains how budget has been spent/implemented and offers forecast for rest of year.	OBS
29		Public disclosure of year-end reports	OBS	Qualitative Milestone Scale	Discloses government balance sheet and sector budget performance	OBS
30		Level of detail explaining difference between enacted and actual levels of expenditure	OBS	Quantitative Milestone Scale	Explains accuracy of expenditures and strength of justification when different from planned	OBS

31	Auditing	External audit function is effective	PEFA PI-26, PFMRAF, Project PMP	Qualitative Milestone Scale	External audit function is evaluated on scope of audits (coverage and auditing standards); Timeliness of audit reports to legislature; evidence of follow-up on audit recommendations by executive or audited bodies; and independence and mandate of the Supreme Audit Institution	PEFA Assessment PFMRAF or PMP
32		Public disclosure of audit report of budget/financial statement	OBS	Qualitative Milestone Scale	Whether government publicly releases audit of government budget/financial statement at end of FY	OBS
33		Two years on, what percent of expenditures audited	OBS	Quantitative Milestone Scale	The amount of expenditures that have been audited two years after taking place	OBS and ISPMS
34		Audit results are used to improve management through legislative scrutiny	PEFA PI-28, PFMRAF, Project PMP	Qualitative Milestone Scale	Legislative involvement in the external audit function is evaluated on timeliness, hearings on key audit findings, issuance of recommendations and follow-ups, and public access to the results of the scrutiny function	PEFA Assessment PFMRAF or PMP
35	Internal Controls	Internal controls for non-salary expenditures are effective	PEFA PI-20, PFMRAF, Project PMP	Qualitative Milestone Scale	Internal controls are evaluated on segregation of duties, effectiveness of commitment controls for expenditures, and effectiveness of payment controls	PEFA Assessment PFMRAF or PMP
36		Internal audit functions are effective	PEFA PI-21, PFMRAF, Project PMP	Qualitative Milestone Scale	The internal audit function is evaluated on the extent to which government entities are subject to internal audit, the specific good practices in audit functions and management responses to their findings, and the nature and characteristics of the internal audits performed	PEFA Assessment PFMRAF or PMP

37	Asset Management	Quality of government financial asset monitoring	PEFA PI-PAMi, PFMRAF, Project PMP	Qualitative Milestone Scale	The registration, verification of ownership, and performance of financial assets are monitored and reported on annually	PEFA Assessment PFMRAF or PMP
38		Quality of government non-financial asset monitoring	PEFA PI-PAMii, PFMRAF, Project PMP	Qualitative Milestone Scale	The registration, verification of ownership, management and statistics on non-financial assets are monitored and reported on annually	PEFA Assessment PFMRAF or PMP

GLOSSARY

Accountability: The systems, procedures, and mechanisms designed to ensure that public officials and institutions perform their duties and responsibilities while recognizing restraints on their power and authority. Accountability also refers to the processes that enable governments to be held responsible for their actions by their citizens, a central tenet of governance.

Accounting: The process of recording, classifying, and interpreting financial transactions that occur within an organization.

Accrual Basis of Accounting: An accounting method where revenues are recognized when goods and services are provided or the right to receive payment is obtained. Similarly, expenses are recognized when the expense occurs or expires or when there is an obligation to pay for goods and services.

Audit: An independent review and examination of system records and activities. Audits are used to verify financial records and statements, evaluate internal controls, assess compliance with internal processes and procedures and legal and donor requirements, detect fraud, and identify potential improvements in processes and procedures.

Automated Directives System (ADS): is a standardized system consisting of (1) USAID internal policy directives and required procedures; (2) external regulations applicable to USAID; and (3) non-mandatory guidance to help employees interpret and properly apply internal and external mandatory guidance.

Budget Authority: The legal authority to incur financial obligations that result in expenditures. It can also refer to a ministry, department or unit of government that receives a budget through the government budget process and is accountable for that budget to the legislature.

Budget Cycle: A key process in any public financial management system governed by the legal framework that can be organized into four components: budget planning, budget preparation, budget execution, and auditing. Reporting occurs throughout the four components.

Budget Planning: The first component of the budget cycle, developing a short- to medium-term budget plan based on the established resource envelope. This component also includes the development of longer term strategic plans and medium term macroeconomic and macro-fiscal frameworks then linked to the budget plan. During budget planning, specific programs are defined at sectoral and activity levels to achieve national goals.

Budget Preparation: The second component of the budget cycle. It generally begins the development of an MTEF and/or with a budget circular published by the agency responsible for budgeting (usually, the Ministry of Finance), providing guidance for administrative and sectoral units on developing their budgets according to an approved Budget Plan.

Cash Basis of Accounting: An accounting method in which revenues are recognized when cash is received and expenditures are recognized when cash is paid for services and/or goods.

Chart of Accounts: The basic building blocks of any accounting system, listing all accounts (categories) used in budgeting, recording, and reporting revenues, expenditures, assets, and liabilities. The COA includes codes that indicate key information, such as the the department or unit responsible for the transaction, the program or purpose, and nature of the transaction. This is also referred to as accounts classification

Civil Society: The non-governmental and private sector organizations and institutions that manifest the interests and will of various publics.

Debt: The outstanding amount that the government owes to lenders at any given point in time. Thus debt essentially represents the total of all annual deficits, minus any annual surpluses, over the years.

Deficit: The difference between one year's revenues and expenditures when expenditures exceed revenues. It only reflects that fiscal year's imbalance. Deficits are funded either with savings or through borrowing or external funding.

Debt Sustainability Analysis: An assessment of the government's ability to make the fiscal policy adjustments (revenue collection and expenditures) needed to achieve solvency. A debt sustainability analysis looks at how the ratio of the debt to Gross Domestic Product, will change over time based on the outlook for the primary deficit, or fiscal deficit, and the interest rate-growth differential.

Expenditures: Government spending (outlays). Expenditures are made to fulfill a government obligation, generally by issuing a check or disbursing cash in physical or electronic forms. Expenditures may pay for obligations incurred in previous fiscal years or in the current year as permitted by law. Expenditures are often subdivided into capital and recurrent. Capital expenditures are those for the acquisition of assets with more than one year of useful life, while recurrent expenditures are those that must be repeated on a regular basis, such as wages, utilities, etc.

External Audit: A periodic or specific-purpose audit performed by a qualified professional independent of the entity being audited , in accordance with laws or rules on the financial statements of a company, government entity, donor, or other legal entity or organization The objective is to verify the accuracy and completeness of the entity's financial information, its compliance with laws, rules, and/or regulations governing its financial and other operations, and sometimes its performance vis-à-vis established goals, objectives, and/or indicators.

Effectiveness: The extent that the development intervention's objectives were achieved or are expected to be achieved, taking into account their relative importance. In partner governments, effectiveness is measured as the extent to which the government's goals, objectives, and indicators are achieved over a defined time period.

Executive Branch: The executive branch of government is that segment of government organizations charged with the management and administration of government functions. The executive branch is thus the administrative arm of government. It is often referred to as the 'administration' or the 'administrative branch of government'. It generally includes most public employees because it operates, implements and enforces all the laws created by the legislative branch, and as interpreted by the judiciary branch.

Financial Management Information System (FMIS): Stores, organizes, and facilitates access to financial information. It supports the reliable collection and dissemination of information throughout the public financial management cycle and provides decision makers with a set of tools to control, prioritize, and use public resources more effectively. It stores financial information related to current and past year spending as well as the approved

budgets for the current year, details on inflows and outflows of funds and complete inventories of financial assets and liabilities. The FMIS may also be integrated with functions including asset controls, budget preparation, human resources, payroll, procurement, and other PFM sub-systems as needed.

Financial Reporting: The communication of financial information to inform interested parties about the decision-making process and enhance government transparency throughout the entire budget cycle.

Fiscal Deficit: A fiscal deficit is caused when expenditures exceed revenues during a budgetary period once all government obligations have been paid and without deducting transfer payments. The payments made include debt obligations.

Fiscal Framework: A tool to establish medium-term fiscal targets with a focus on fiscal position, fiscal sustainability, and fiscal vulnerability. The fiscal framework is informed by the macroeconomic framework, and includes revenue and expenditure projections disaggregated by various categories.

Fiscal Sustainability: The ability of a government to sustain its current spending, tax and other policies in the medium to long term (3 to 10 or more years) without threatening government solvency or defaulting on its liabilities or projected expenditures.

Fiscal Vulnerability: When government fails to ensure adequate financial resources to meet all its payment obligations. Large fiscal deficits or public debt are leading indicators that fiscal policy is vulnerable.

Fixed Asset Register: An accounting method used to keep track of the fixed assets of a firm or government. The register shows the value of assets, date of acquisition and other details necessary to compute for depreciation, control and tax purposes. Fixed assets include land, buildings, machineries and other items used in the business that are not for sale in the ordinary course of operations.

General Ledger: An organization's primary accounting records containing a complete record of financial transactions over its life. Information from the general ledger is used to prepare financial statements. The general ledger generally includes accounts for budget, assets, liabilities, revenues, and expenses consistent with the chart of accounts.

Good Governance: Governance that respects the democratic rights and interests of stakeholders while promoting government accountability, transparency, and efficient and effective delivery of public services and the rule of law.

Governance: The exercise of authority, involving the process and capacity to formulate, implement, and enforce laws and public policies and provide public services.

Government Cash Management: The management of cash inflows and outflows to maintain liquidity so that the government is always in a position to meet its obligations as they become due. Government cash management deals with both collections (sources of funds) and disbursements (use of funds).

Gross Domestic Product (GDP): The market value of all finished goods and services produced within a country during a specific time period. It includes all private and public consumption, government outlays, investments, and exports less imports. Real GDP, as opposed to nominal GDP, is adjusted to remove the effects of inflation. Per capita GDP is the GDP divided by the population of the country.

Imprest Fund: A cash fund with a fixed amount established through an advance of funds to an authorized imprest fund cashier, without appropriation change, for immediate cash payments of relatively small amounts for authorized purchases of goods and non-personal services.

Interest Rate-Growth Differential: The differential between the interest rate paid to service government debt and the growth rate of the economy.

Internal Audit: Frequent or on-going audits conducted by an entity's own accountants, rather than independent external auditors. The objective of internal audit is to identify risks and weaknesses in the financial and operational control environments and to develop recommendations to mitigate or rectify them.

Internal Controls: Systems, policies, and procedures to reasonably ensure orderly, ethical, and efficient operations in accordance with the organization's mission; compliance with laws and regulations; and reduce risks of waste, fraud, abuse, and mismanagement. These include segregation of duties within processes; appropriate authorization of transactions; safeguards over inventory and assets; efficiency of processes or operations; good record keeping and documentation; and reporting and use of the information.

International Public Sector Accounting Standards (IPSAS): A set of accounting standards issued by the IPSAS Board recommended for the preparation of financial statements by all public sector entities in. These standards are based on International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). They are used to improve the quality of general purpose financial reporting by public sector entities for better informed assessments of the resource allocation decisions made by governments for greater transparency and accountability.

International Organization of Supreme Audit Institutions (INTOSAI): A governing and participatory body dedicated to the improvement of public external auditing standards and practices. Many national Supreme Audit Institutions belong to this group

Judicial Branch: The segment of governing institutions that includes courts or other bodies charged with making rulings based on laws or interpreting the laws of a country. In certain governance systems may include prosecutorial and other bodies whose responsibilities include participation in the system of adjudication. In some countries the judicial branch may be effectively part of the executive branch of government or be partially under its control through appointments or influence.

Legislative Branch: The segment of government, whether elected or appointed, that is responsible for the passage of primary legislation, or the laws under which a country is governed. Ideally, legislatures are primarily elected by the citizens. In good practice public financial management legislatures approve government revenues and expenditures through a budget law. The primary institutional components of legislative branches include parliaments, congresses, assemblies, councils, or similar bodies and their integral supporting units.

Line Item Budgeting: Budgets are based on the cost of specific categories of inputs (e.g., salaries, electricity, and fuel). Line item budgets focus on the resources spent, but do not provide information on the intended results. Also known as Input Budgeting.

Macroeconomic Framework: Projections of the real, external, fiscal, and monetary sectors based on a set of macroeconomic goals and policy framework. The macroeconomic framework assesses domestic and global economic trends to estimate the resources that will be available to the government.

Macro-Fiscal Framework: The macro-fiscal framework draws on the macroeconomic and fiscal frameworks to estimate a resource envelope based on projected revenues and expenditures for a 3–5 year period. These revenue and expenditure amounts appear in the medium-term expenditure framework and annual budgets and are an integral part of the budgeting process and the PFM system. These may also be referred to as medium-term fiscal frameworks.

MDA: Ministries, Departments, and Agencies. MDA are organizations and/or institutions that are primarily funded through a government’s budget and are responsible for government operations, policies, and the provision of government services with those funds. Such organizations may additionally include those identified by any and all terms used to refer to government entities, including departments, offices, etc.

Medium Term, Short-Term, and Long-Term: In general PFM and governance practice, short term refers to periods of less than 3 years, medium term to periods of between 3 and 5 years, and long term to periods exceeding five years.

Medium Term Expenditure Framework (MTEF): The expenditure portion of a Medium Term Budget Framework and a critical tool during the budget preparation process that translates strategic objectives and priorities into financial figures over the medium-term. It links the top-down resource envelope (what is affordable based on the aggregate expenditure ceiling established through the medium-term fiscal framework) to the bottom-up cost estimates (what is needed) prepared by spending agencies. It provides a medium-term framework for policy makers to decide on program priorities and make political choices as the budget is being prepared.

Medium Term Budget Framework (MTBF): A framework for integrating fiscal policy and budgeting over the medium-term by linking aggregate fiscal forecasting to a disciplined process of maintaining detailed medium-term budget estimates by ministries that reflect existing government policies.

National Budget: A legal document authorizing government officials to spend public funds within pre-agreed constraints. The budget allocates resources and thereby expresses the policy priorities of the government. Such documents may include items directly related to the achievement of goals and objectives by government as well as program descriptions and performance reporting

Office of Management and Budget (OMB): The Office of Management and Budget (OMB) is an agency of the United States of America’s federal government that evaluates, formulates, and coordinates management procedures and program objectives within and among departments and agencies of the executive branch.

Organization for Economic Co-operation and Development: The OECD is an international economic organization of 34 countries founded in 1961 to stimulate economic progress and global trade. It is a forum for countries committed to democracy and a market economy that offers a platform to compare policy experiences, seek answers to common problems, identify good practices, and coordinate domestic and international policies of its members.

Parastatals: A company, entity, organization or agency owned or controlled wholly or partly by the government. Examples might include state owned enterprises, universities, joint stock companies, etc.

Petty Cash: A small fund of money for rapid reimbursement of incidental expenses of an operating unit.

Primary Deficit: A country's primary deficit is caused when expenditures exceed revenues during a budgetary period once all government obligations have been paid before deducting interest payments on debt or government obligations.

Program Budgeting: A type of budget that groups revenues and expenditures by program, regardless of the number of budget institutions involved and shifts the focus from resource input to service delivery.

Public Expenditure and Financial Accountability (PEFA): A multi-donor partnership of seven donor agencies and international financial institutions founded in 2001 to assess the conditions of country public expenditure, procurement and financial accountability systems and develop a practical sequence for reforms and capacity development. A steering committee manages the program and a secretariat implements the activities.

Public Financial Management (PFM) System: The national or sub-national government policies, procedures, and infrastructure for planning, directing, controlling, monitoring, and reporting on public financial resources intended to result in efficient and effective operations.

Public Investment Program (PIP): A phased, multi-year (3-5) program within an administrative unit or sector that aims to facilitate efficient and effective capital investments or improve management of donor financing.

Public Procurement: The use of public funds by public entities for purchasing goods and services from the domestic or international private sector or civil society organizations. Also, the processes used for such transactions.

Responsiveness: The extent to which a government meets the needs perceived by its citizens and can react to changing conditions.

State Owned Enterprises: A shareholding arrangement in which a government entity has a controlling or minority ownership interest that allows it to exercise management control over a business providing services to non-state entities.

Strategic Plan: A plan that covers an extended period (usually 5 years or more) and that identifies national priorities and policies, generally without fiscal components. Sectoral or institutional strategic plans can also be developed in line with a national strategic plan.

Supreme Audit Institution (SAI): A national organization that sets standards for audit work and generally controls the external audit processes for the government.

Transparency: A form of accountability that is based on accessibility and openness of information. Transparency may be internal or external (public).

Treasury Single Account (TSA): A unified structure of government bank accounts that gives a consolidated view of government cash resources. Based on the principles of the unity of cash and the treasury, a TSA is a bank account or a set of linked accounts that all governmental entities use in for revenue and payment transactions.

Zero-Based Budgeting (ZBB): A budgeting technique based on the principle that all prior allocations need to be re-justified every year, rather than assuming continued baseline funding. Zero-based refers to the fact that each major budget item is reviewed as thoroughly as if it had not been funded in the previous year. Since this is a time-consuming and data-intensive approach that does not take political realities into account, it is rarely used in practice, although partial or modified ZBB is often a component of a single budget process.

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