Medium Term Budget Framework Manual

Iraq

Working Draft Only

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Acronyms

CoA	:	Chart of Account
BOPA	:	Budget Outlook Paper
BPG	:	Budget Procedures Group
BSP	:	Budget Strategy Paper
BSC	:	Budget Steering Committee
CoFoG	:	Classifications of Functions of Government
GDP	:	Gross Domestic Product
GFS	:	Government Financial Statistics
GoI	:	Government of Iraq
GRB		Gender Responsive Budgeting
IFMIS	:	Integrated Financial Management System
IPSAS	:	International Public Sector Accounting Standards
MIS	:	Management Information System
MoF		Ministry of Finance
MPER	:	Ministerial Public Expenditure Review
MTEF	:	Medium Term Expenditure Framework
MTBF	:	Medium Term Budget Framework
MTFF	:	Medium Term Fiscal Framework
MWG	:	Macroeconomic Working Group
NGO	:	Non-Government Organization
PBB	:	Program-Based Budgeting
PER	:	Public Expenditure Review
PRS	:	Poverty Reduction Strategy
SCOA	:	Standard Chart of Accounts
SWG	:	Sector Working Group

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I. NOTE ON THE MANUAL

A. What is this Manual?

1. **This manual is intended to serve as a guide in the full development over the coming years of the Iraq system of Medium Term Budget Framework (MTBF) .** The manual contains an introduction to medium term budgeting and practical guidance on how to proceed. This manual supplements all other budget manuals applicable for the Government of Iraq.

B. Who should use this manual?

2. **This manual guides Budget Users throughout the whole process of preparing budgets using medium term budget methodology for all levels of government.** The various parts of the manual serve the familiarisation and better understanding of budget preparation, execution and control of each government official involved in the process.

C. How should this manual be used?

3. **The manual serves as a baseline tool to assist the Government to implement necessary fiscal management reforms.** These guidelines have been developed with the aim of serving both as desk references for government officials already trained in the respective fiscal competency as well as training tools for structured capacity-strengthening programs.

D. What this manual is intended to do?

4. **This manual should assist officers involved in budget preparation and execution to understand public sector budgeting by placing the MTBF methodology in the context of some of the budgeting reforms that have been successful internationally.** This manual is intended to assist line ministry officials and budget agencies in their understanding as to how develop a medium-term budget projection and submit this to the Ministry of Finance.

II. INTRODUCTION

5. The Government prepares the annual budget that is submitted to Parliament in accordance with the Constitution of Iraq and other written laws. The budget should include estimates of Government revenues and expenditures and is prepared under Medium Term Budget Framework (MTBF).

A. Medium-Term Budget Framework (MTBF) Defined

6. MTBF is a transparent planning and budget formulation process that attempts to improve the decision making process so as to link Government policies, priorities and requirements within limited resource constraint. The key features of the MTBF approach are:

(i) A medium-term perspective to budget planning;

(ii) An explicit linkage between policy priorities and resource allocations; and,

(iii) An emphasis on the efficient use of limited public resources.

1. MTBF Objectives

7. In introducing the MTBF, the Government seeks to address the following objectives:

- to provide a comprehensive and realistic framework for the planning and management of public expenditure;
- to increase the predictability of resources through a structural budget planning process that provides more reliable estimates of revenues and expenditures over a three year period;
- to better link resource allocation processes to government policy and program priorities;
- to restructure and rationalize resource allocation so that priority areas receive adequate funding;
- to improve the basis of the budget by moving away from the incremental approach to estimating the actual costs of Government activities in delivering goods and services and integrating the preparation and presentation of the recurrent and development budgets; and,
- to introduce a forward or medium term perspective in the planning of policies, expenditures and revenues

2. **Main Elements of an MTBF**

8. The MTEF revolves around four primary elements:

- **<u>A macro-fiscal framework</u>** - that: (i) looks at how macroeconomic developments can be expected to affect government revenues and expenditures; and (ii) provides a medium-term projection of revenues, expenditures, the budget deficit and its financing.

- **<u>An analysis of key budget planning and management issues</u>** - in recent years, these have included management of the public service wage bill, public investment management and the financing of local authority budgets.

- **<u>An analysis of spending priorities</u>** - that looks at how the government's strategic policy and program priorities should be influencing resource allocations between and within sectors.

- **<u>Expenditure plans</u>** – that provide three-year sector and ministry level resource ceilings and identify the key spending priorities at program level.

3. Key Features of MTBF Reform

9. The reforms that MTEF seeks to institutionalize put emphasis on three complementary and interrelated objectives:

- **Aggregate financial discipline.** Control of budget aggregates (revenues, expenditures and the deficit and its financing) is the first requirement of any budget management system.

- **Efficient Allocation of Resources.** Budgetary expenditure allocations between and within sectors should reflect and be consistent with government policies and priorities. Resources should be progressively reallocated from lesser to higher priority programs, from old priorities to new, and from less to more effective programs.

- **Technical efficiency.** Public agencies should embrace on-going efficiency strategies in order to deliver high level of public services at the lowest cost.

4. Attributes of the MTBF

10. A well formulated MTBF process should have the following attributes:

- **Provide a multi-year time horizon**: provide a multi-year time horizon (three years) for the planning and programming of public expenditure, recognizing that government policies and their associated public expenditure implications are implemented over a period of time.

- **Disciplined process using top-down hard budget constraints**: be based on a macro-economic framework and explicit fiscal policy considerations, providing budget totals that are explicit and are set prior to the determination of individual spending allocations; and, provide hard budget constraints levels within which trade-offs are made.

- **Bottom-up preparation of spending plans**: include a bottom-up approach in which line ministries/departments and other lower units specific expenditures are to be reconciled to sector policies and programs within the available resources. This follows consultations with a broad alley of stake-holders including the beneficiaries themselves.

- **Comprehensiveness**: (i) be inclusive of central and local government budgets and of extra-budgetary funding, acknowledging and analysing the inter-relationship between these different elements of public spending; (ii) cover both recurrent and investment expenditure recognizing the importance of achieving an appropriate balance between investment in public services and the downstream funding requirements for operations and maintenance; and, (iii) be inclusive of all domestically and externally financed public expenditure, including externally financed projects, acknowledging the need to coordinate the use of external funds avoiding duplication and ensuring complementarity of spending.

- **Be based on sound information about costs:** have good information on the cost of spending proposals. The forward cost of implementing existing programs should be known and defined as baseline spending. In addition, new policy proposals should be properly costed before they are adopted for implementation.

- **Demand accountability for performance:** allocations should be justified against projected outputs and policy outcomes and be linked into a monitoring and evaluation system that demands accountability for the results achieved from spending agencies.

- **Contestability of priorities:** provide a forum on the basis of policies and priorities, where programs compete for the limited resources.

- **Transparency**: The MTBF budget should be transparent to allow scrutiny by the public and the oversight authorities including Parliament and the National Audit Office.

5. Challenges in Adopting an MTBF Approach

11. Improving the way public resources are allocated and used requires changes to more than just the budget system. It requires:

- Changes to the way the use of resources is measured and reported, including monitoring and reporting of the outputs that are produced;

- Accounting and reporting that is transparent and useful to Parliament and the public, to enable them to hold Government to account;

- Accounting systems which enable managers to deliver services effectively with the resources they have been allocated;

- Internal controls and monitoring to ensure that resources are properly used for the purposes intended.

- Internal and external audit to buttress internal controls and to ensure accountability by Government for its stewardship of resources;

- Incentive structures that promote skills development within the public sector; and,

- Timely preparation of audit reports by the National Audit Office.

6. MTBF Budget Cycle

12. The MTBF approach places government policies and priorities at the centre of budget planning. It provides a realistic budgetary resource ceiling against which to prioritise the allocation of resources consistent with policy objective. It also requires effective mechanisms for the monitoring of budgetary inputs, outputs and outcomes and for feedback of monitoring information into the subsequent expenditure planning cycle (see figure 1 below).

13. The MTBF cycle therefore has the following key elements which are interrelated:-

- **Policy development:** This is contained in various government documents and party manifestos. The policies set the platform on which budget decision is made.

- **MTBF budget process:** The budget is a process that commences with review of the previous year's performance, determining the macro fiscal framework and ends with the budget being submitted to and approved by the appropriate National and Subnational government entities..

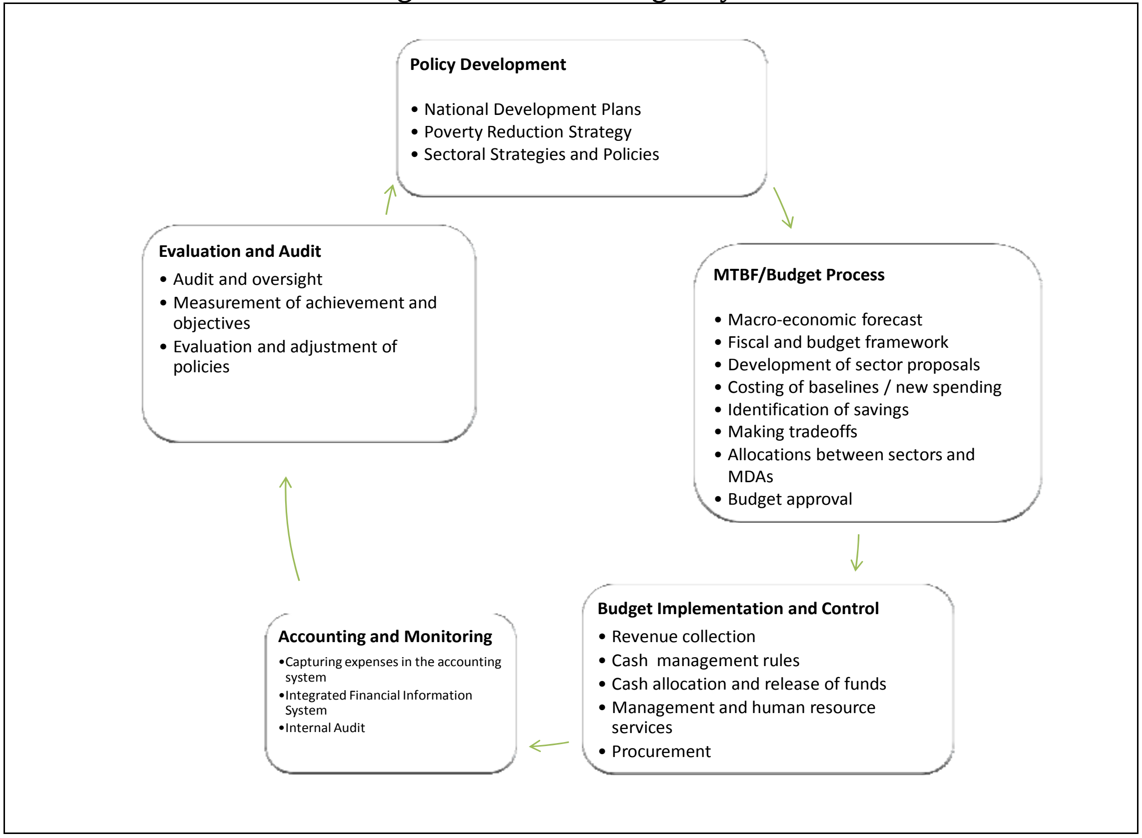
- **Budget implementation:** This involves implementation of programs and projects, and control as approved by the appropriate National and subnational government structures.

- **Accounting monitoring**: This stage of the cycle involves accounting for all use of resources, reporting and monitoring of budget performance. It also involves internal audit to ensure that due processes are followed and that there is compliance with procedures.

- **Evaluation and Audit:** This involves measurement of achievement of outcome and results, as well as audit of Government operations and oversight by National and County Assemblies. The challenge for this process is the identification of achievement indicators.

The MTBF budget cycle is summarized in the figure below.

Figure 1: MTBF Budget Cycle

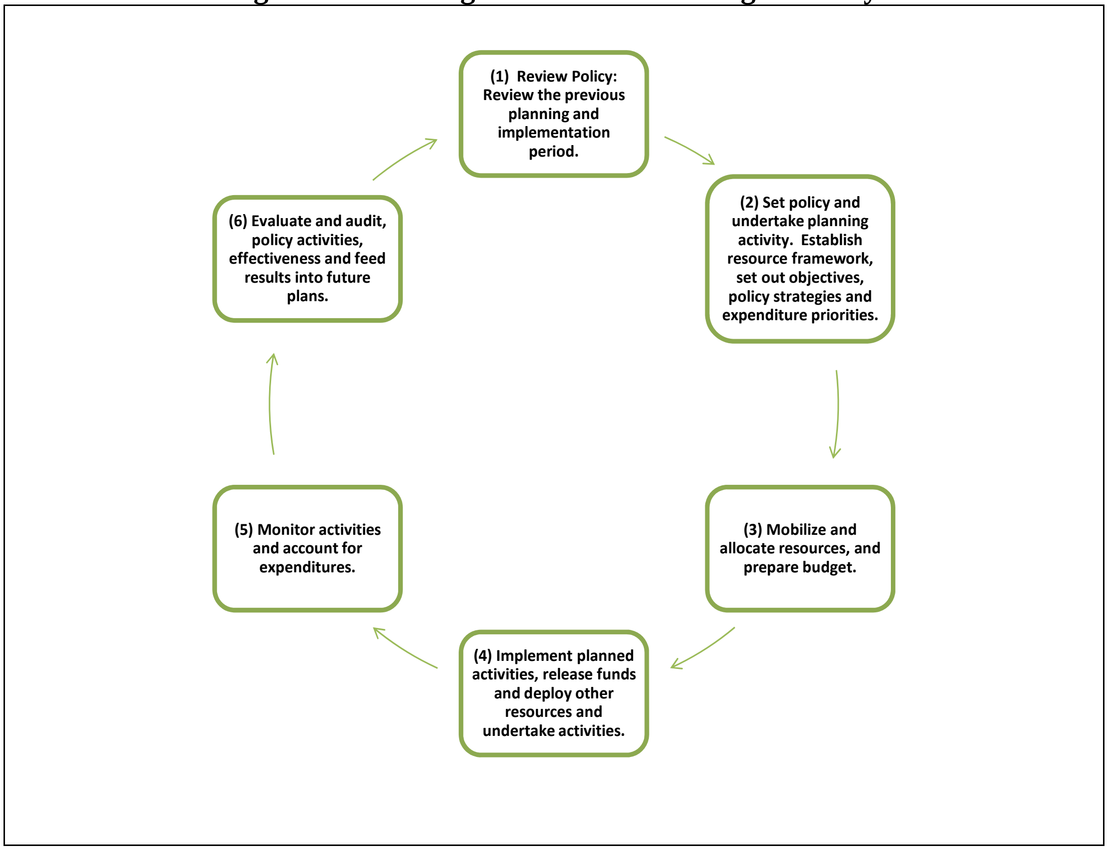


B. Linking Policy, Planning and Budgeting

14. As can be deduced from the Figure 1 above, for a budget to achieve its desired goals, it is critical to link policy planning and budgeting in the planning and resource management cycle. The absence of the critical linkages policy making and planning are not only disconnected from each other but also from budgeting.

15. Integrated policy, planning and budgeting is all about developing expenditure programs that are driven by priorities and anchored on budget realities. This is prudent to ensure that resources are allocated on the basis of clear policy choices to achieve strategic objectives. These linkages are demonstrated in the generic diagram below:-

Figure 2: Planning and Resource Management Cycle



1. Current Forward Budget Process

16. **The Government of Iraq currently prepares two budget estimates: one for recurrent operations and another for the development budget**. The annual process is co-ordinated by the Ministry of Finance, which issues annual budget ceilings for the recurrent and development budget. Thereafter, each ministry prepares its itemised budget and submits it to the Ministry of Finance for review, approval and compilation.

17. **Through internal reviews of the performance of the budget process, the Government of Iraq realises that its public expenditure management is inconsistent with the objective of achieving the high and sustained growth of the economy.** The current situation requires a reform of public expenditure management, spanning from budget formulation to budget implementation. On the basis of these internal reviews, the government is considering adopting a Medium Term Budget Framework (MTBF), which would guide the efficient and effective use of government resources over a multi-year period.

2. Ministry of Finance - Next Steps in Introducing an MTBF

18. The Ministry of Finance is considering, over the medium term, to:-

- Provide for a hard budget constraint by giving ministries and other spending agencies a 3-year ceiling on expenditures;
- Establish the cost of programs, particularly the future cost implications of current investment in facilities;

- Establish a process of reviewing priorities and linkage to available resources;
- Provide for identification of future requirements generated by present policies;
- Provide a criterion for reviewing the performance of on-going as well as future programs (the forward budget was assumed to be the only mechanism for the introduction of new programs); and,
- Provide/establish a linkage between planning and budgeting.

C. The MTBF Process and Key Instruments

19. The proposed Government of Iraq MTBF process can be summarized in three primary stages:

1. Macro target setting/estimation of the overall resource envelope;
2. Review of sectoral policies; and,
3. Financial programming.

1. Macro Target Setting – Estimation of Overall Resource Envelope

20. This is the first stage and is a top down process. In this Handbook, this stage of the process is discussed in greater detail in the section entitled "Under Macro-fiscal Policy". This stage involves setting of macro targets including projected economic growth, desired inflation rate, money supply, projected interest rates, desired levels of borrowing both domestic and external, and other macro aggregates which include realizable revenues and sustainable expenditure levels.

2. Review of Sectoral Priorities

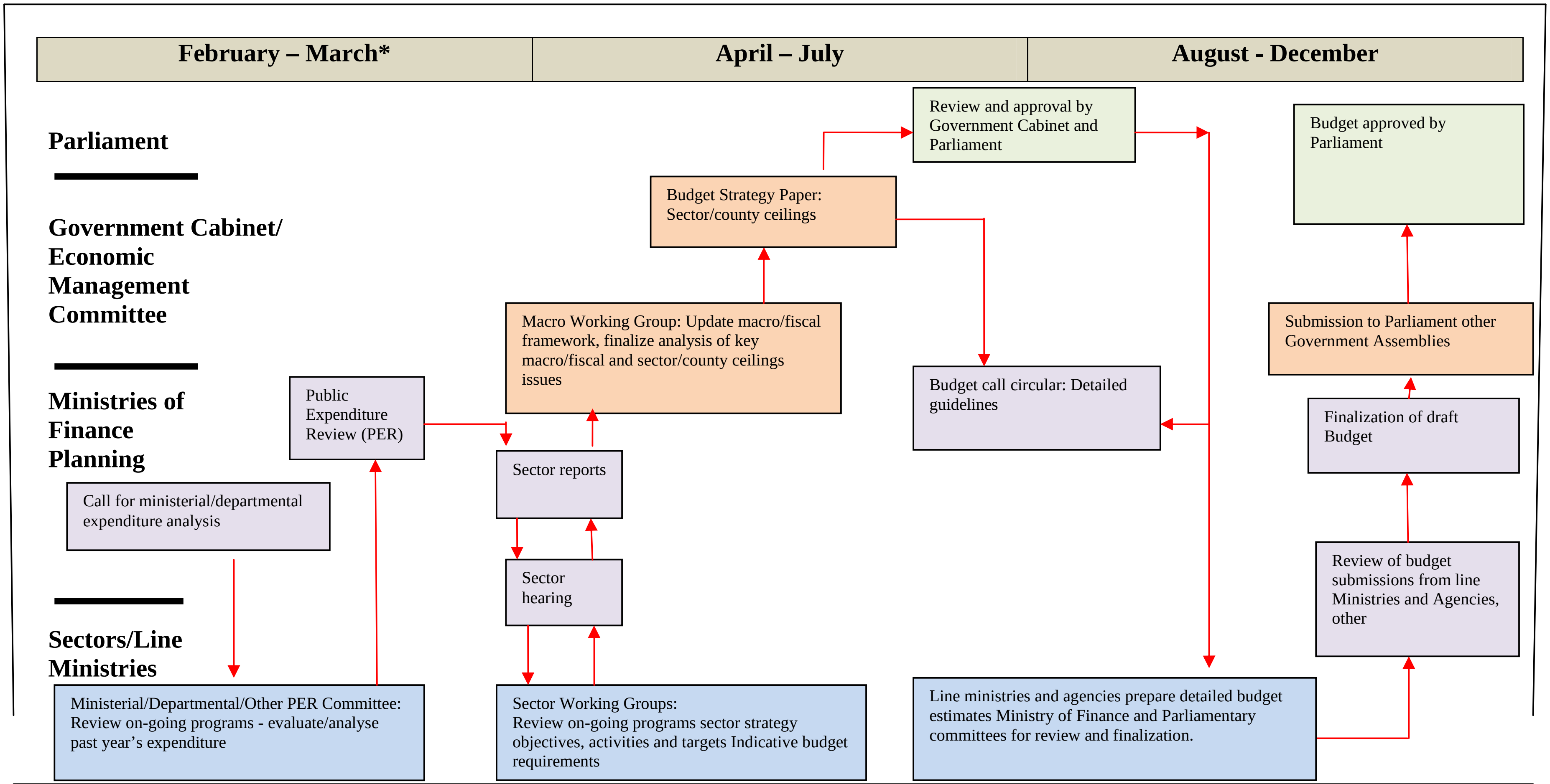
21. The sectors and the Ministries/departments review past performance against policy priorities as contained in the strategic plans and prioritize for funding. The Sectors are required to develop criteria for prioritizing and allocating resources to programs. This is considered a bottom-up process. In this stage, program out-puts and outcomes are defined and targets to be set are clearly identified. These form the basis for subsequent monitoring and evaluation.

3. Financial Programming

22. The third stage is the financial programming stage which is also the preparation, consolidation and approval of the itemized budget. Once the Ministries/departments have received their expenditure ceiling, the next step is to prepare itemized budget estimates for both recurrent and development.

23. The Ministries/departments are required to strictly adhere to the ceiling and guidelines. The Ministry of Finance will then approve and consolidate the final estimates for the National Government, and Parliament, respectively. The proposed MTBF process is illustrated in Figure 3, below.

Figure 3: MTBF Budget Calendar



NOTES*
The time periods given in the plan are tentative but based on practical experience. The commencement months/dates vary depending on the circumstances/operational challenges prevailing.

III. THE MACRO-FISCAL FRAMEWORK

24. This chapter focuses on the top-down perspective of the MTBF process proposed for Iraq. It describes government's fiscal policies which determine the macro-economic framework for developing MTBF budget. This chapter consists of two sections; the first section looks at fiscal policy objectives and targets and the second at the macro-fiscal framework.

A. Medium Term Fiscal Policy

25. The budget process starts with a top-down consideration of macro-economic outcomes, fiscal outcomes and the preparation of robust revenue projections. These processes generate an indicative budget framework within which sectors compete for resources, as do spending Ministries/departments within sectors.

26. The macro-fiscal framework is determined and approved through a sequenced process that aligns inputs by different actors to ensure availability of information and expertise. The table below illustrate the Macro-economic and Fiscal Framework.

Table 1: The Macro-Economic Framework

Iraqi Dinar (million)	Budget Year (T -2)	Budget Year (T-1)	Current Budget Year	Budget Year (T+1)	Outer Year (T+2)	Outer Year (T+3)
	Actual Outturn	Actual Outturn	Projected Outturn	Projected	Projected	Projected
GDP volume						
Overall Inflation						
International Reserves						

27. On the basis of these frameworks, the Ministry of Finance proposes indicative ceilings within which the Sector Working Groups (SWG) should prepare Sector Budget proposals. Indicative sector resource ceilings are decided upon by taking into consideration:

- The national objectives of enhanced economic growth and poverty reduction.
- The proposed inter-sectoral priorities, guided by strategic budget process for the medium term endorsed by the cabinet.
- Baseline spending requirements and the medium term adjustments based on hard budget constraints and historical allocations.
- Other Financial Commitments through project loans and grants.

1. Development of Fiscal Policy

28. Fiscal policy is concerned with the levels and composition of taxation, spending and borrowing by government. Fiscal policy encompasses fundamental policy issues, including the role and size of the state and future state of the economy (because borrowing imposes a burden on future generations, whereas investment provides future benefits), the role of government in promoting growth, job creation , equity considerations, and the amount and type of public services that are provided.

29. The Iraqi Government's fiscal policy has both macroeconomic and microeconomic objectives. Macroeconomic policy deals with the evolution of the economy as a whole including national income and output, jobs, inflation and the balance of payments. The macroeconomic objectives of fiscal policy primarily require government to pay close attention to the *overall level* of taxation, spending and borrowing, keeping them at levels which promote investment and sustainable growth. They also require the Government to focus on the *composition* of government spending to ensure it promotes economic growth.

30. Micro-economic policy outlines the distribution of income and wealth, the efficiency with which the public and private sectors are able to produce goods and services, and the responsiveness of public services to the needs of citizens who use them. The microeconomic benefits of fiscal policy are largely delivered through the allocation and *efficient use* of public resources and the maintenance of an effective tax system. The *overall level* of taxation and spending have microeconomic implications, which include the effect of increased borrowing in the domestic financial market, interest rates, prices and disposable incomes at the household level.

31. Fiscal policy also needs to focus on setting desirable limits and forecasting on external financing of Government programs through grants and loans. External resources have an impact on the external account aggregates. The unpredictability of external resources pose particular challenges for setting fiscal policy objectives and fiscal targets.

32. The objectives of fiscal policy include:

- Achieving a manageable debt position and maintaining a sustainable fiscal framework;
- Addressing issues of equity and poverty reduction through increased spending on key social sectors and improved targeting within social sectors; and,
- Directing expenditure outlays from that of the state as a producer to the state as a facilitator of growth.

2. Policy Framework

33. Key budgetary considerations for credible fiscal policy are realism and honesty in fiscal forecasting, transparency and government's ability to set and enforce a hard budget constraint at an aggregate level and for all institutions that have a claim on the public purse, during both the budget planning process and implementation.

34. An effective fiscal policy therefore requires a high level of fiscal and budget transparency, which in turn is dependent on efficient accounting and reporting systems. Providing good information about Government's actual fiscal operations is critical if MTBF/budgeting system is to be transparent. Developing, approving and publishing fiscal policy objectives and the resulting macro-fiscal targets and framework need to be institutionalized appropriately in the budget cycle.

B. The Macro-Fiscal Framework

35. The macro-fiscal framework provides the basis for projecting public expenditure allocations over the medium-term and sets the context against which key budget issues relating to revenues, expenditures and the financing of the budget deficit will be

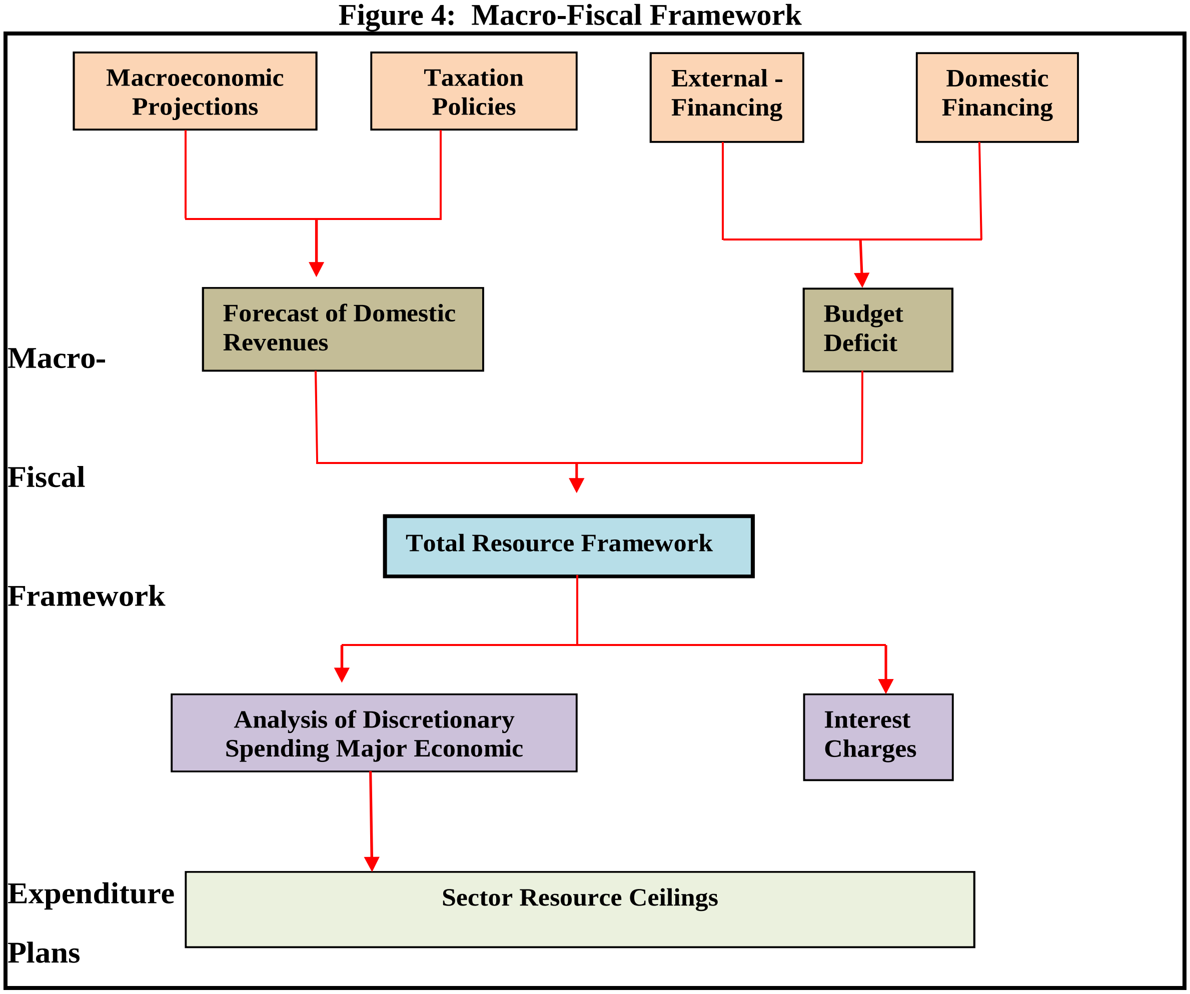
executed. It involves making resource projections that are expected to be available to finance public expenditures over the medium-term.

36. A sound macro-fiscal framework is a pre-condition for effective budget management. This provides an accurate projection of revenues and expenditures. A weak framework therefore not only affects a country's ability to manage its public finances prudently but also affects its ability to make the best possible decisions about which programs should be funded and the appropriate time to do so.

37. The main elements of the framework and their function in the MTBF/budget process are shown in the Figure 4, below. A macro-fiscal framework comprises:

- A discussion of the medium-term macroeconomic outlook;
- A projection of public revenues and a discussion of the underlying trends and assumptions;
- A projection of financing of the budget deficit and discussion of the underlying issues;
- A breakdown of the main expenditure aggregates distinguishing between statutory and non-statutory expenditures.

Figure 4: Macro-Fiscal Framework



38. The capacity of the Government to raise revenue to pay for the delivery of goods and services depends on the overall level of economic activity. Preparing an MTBF fiscal framework requires a focus on projecting macroeconomic aggregates that have the greatest influence on the fiscal framework. Of these, GDP and the inflation rate are the most important factors that influence the growth of both revenues and expenditures. The exchange rate is also important because of its impact on external financing of and external payments from the budget. Changes in the balance of trade similarly affect revenues on external trade and related taxes.

1. Revenue Projections

39. **Public revenues comprise tax revenues, non-tax revenues, dividends from state corporations, external grants, and social fund contributions accruing to both central and local governments.** The projection of revenues over the medium-term needs to be informed by:

- An understanding of recent domestic revenue trends and the factors underlying them;
- A determination of the "tax component" GDP;
- An assessment of agreed or planned tax policy changes and their expected impact on revenues; and,
- An assessment of the scope for improvements in revenue administration.

40. Based on this analysis, an initial projection should be made of revenue as a share of GDP for each of the main revenue sources.

2. Financing a Budget Deficit

41. The budget deficit is affected by two factors:-

i. The level of foreign concessional financing available to the Government; and,

ii. The level of domestic and external financing deemed appropriate for fiscal stability.

42. Issues attached to macro-fiscal framework include:

- **Comprehensiveness** – all expenditure items should be included in the framework (including transfers to public enterprises, etc.,);

- **Risk Management** – the framework must make some allowance for risk (i.e., external macro-economic shocks, natural disasters or unexpected liabilities falling due). Medium term expenditure frameworks often include larger contingency provisions in the outer years, to manage uncertainty. The provision is reduced and allocated as the framework rolls over. A much smaller contingency for the budget year is then finally allocated in a supplementary budget process to areas of need. Other mechanisms are proper assessment of contingent liabilities, including publishing information on them, and being conservative in revenue estimates.

- **The quality of data** – if the macro-economic or revenue projection models are weak, the quality of the framework is affected. Similarly, if government does not have proper information on the forward cost of existing services and the cost of new policy proposals, it may undertake projects and approve new policies that are not realizable within the planned framework.

- **Supplement** – the planned macro-fiscal framework is only as good as its implementation. When the budget is weak in-year decisions become more significant for determining what will be financed. Even if the approved macro-fiscal framework is based on accurate data and the result of a robust competitive process, it will be undermined by in-year decisions. A quality framework is unlikely to result from the budget preparation process, when all actors know that it will have little or no effect. Implementation discipline is a pre-condition for planning rigor.

C. A Budget Outlook Document

43. The primary instrument driving the preparation of macro-fiscal framework is a Budget Outlook Policy document which is prepared by Ministry of Finance in conjunction with Ministry of Planning. The Budget Policy Document elaborates the medium term fiscal framework that determines the overall resource envelope and provides the background and parameters which would form the basis for the detailed budget. This document:

- Signals Government's budget policy intent to important stakeholders outside of the Central government, the private sector, civil society and development partners.
- Provides budgetary decisions regarding fiscal policy and likely available resources, thereby providing a platform for a sound subsequent budget process.
- Links on-going fiscal and budget policy to mid-term development objectives and strategies.
- Establishes the strategic allocation process by providing sector ceilings, within which individual spending Ministries, Departments and Agencies will bid for resources.
- Sets the tone for the medium term budget preparation process

44. The macro-fiscal process and its outcomes are governed by a set of decision-making requirements that seek to maximize budgetary outcomes. The requirements are aimed at ensuring that government will undertake only those activities that it can finance in the resource envelope. The framework will enhance the predictability of resources and will not be vulnerable to financial crisis. Within the macro-fiscal framework there should be competition for public resources, which results in:

- Shifting funds from low priority to high priority activities; and,
- Instituting financial discipline whereby only available resources are allocated.

45. The macro-fiscal framework should also minimize the accumulation of pending bills. The macro-fiscal framework requires the Government of Iraq to:

  - Take into account external financing whose commitment is fully confirmed.
  - Not include development partner budget support flows into the core fiscal framework on account of their high unpredictability; and,
  - Commit to the fiscal framework.

46. The macro-fiscal framework should be comprehensive designed to include all public revenues, expenditures, and contingent liabilities.

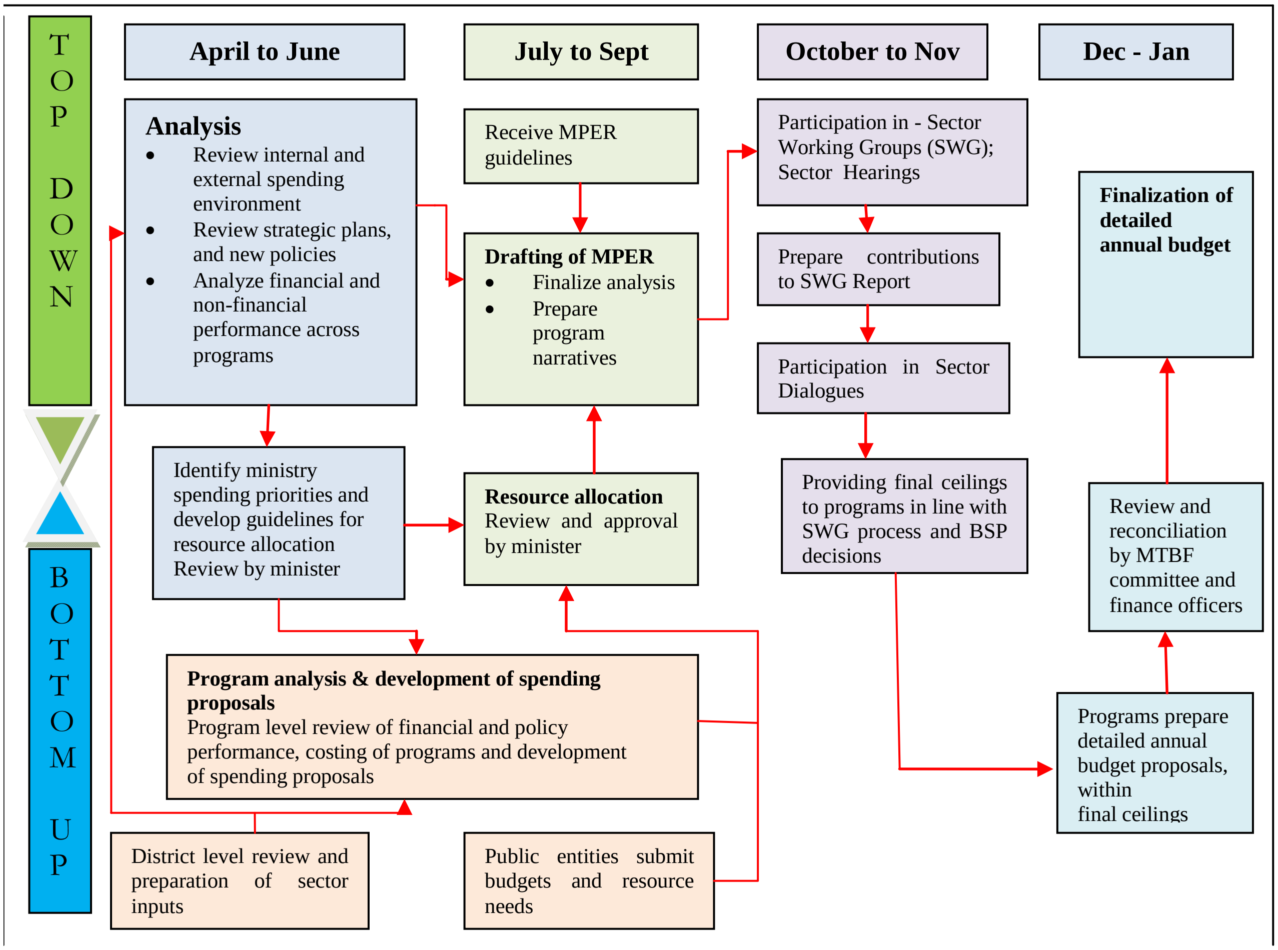
IV. MTBF BUDGETARY ALLOCATION PROCESS

47. This chapter addresses the central challenge of public budgeting which involves allocation of scarce resources to competing priorities. It addresses the issue of expenditure review, establishing baselines, costing of programs and structure of budget.

A. Ministerial MTBF Process

48. The preparation of budget estimates under MTBF involves matching Ministries/Departments/Agencies with total resources based on overall spending priorities. The MTBF process involves the preparation by Ministries of strategic plans in line with the government's current priorities. On the basis of the strategic plans, Ministries must produce an integrated budget that reflects the cost of policies. The MTBF multi-step budget process is indicated in Figure 5, below.

Figure 5: MTBF Budget Process



Source: MTBF Manual (Iraq Budget Process)

49. The capacity of the Government to raise revenue to pay for the delivery of goods and services to Iraqis depends on the overall level of economic activity. While external grants can supplement domestic revenue over the short term, it is not sustainable. The only sustainable source to fund Government's activities to develop Iraq is the economy itself. It follows that the starting point for preparation of the MTBF is an analysis of the underlying prospects for the economy and of Government's macro-level economic and fiscal policies and strategies.

50. The above table illustrates the following steps:

- **Step 1:** A review of the Ministry's programs against its functions and objectives to establish their relevance.

- **Step 2;** At Ministry level, the analysis of past expenditures and performance is undertaken. The preparation of program spending proposals and performance targets are then developed.

- **Step 3:** The development of Ministry/departments and agency (MDA) allocation proposals, matches resource availability with spending needs through a process of trade-offs.

- **Step 4:** The preparation of the Ministerial Public Expenditure Review (PER) entails utilizing and updating earlier spending and performance analysis, documenting resource allocation decisions, performance commitments and output targets and providing an assessment of public expenditure and human resource management in the Ministry/departments. The PERs review the previous year's budget allocation against expenditures and set targets for the following year's budget proposals.

Figure 6: Ministerial Public Expenditure Reviews (PER)

Ministerial Public Expenditure Reviews:

- Ministerial Public Expenditure Reviews (PER) institutionalizes a review of the performance of the Ministry's/Departments/Agencies (MDAs) spending against policy and drives the systematic and strategic allocation of resources within the Ministry's/Departments.

Purpose of a Public Expenditure Review (PER)

- **Public Expenditure Reviews fulfil several basic functions in the budget process, including:**
    1. Provides the basis through which MDAs communicate their past performance, current situation, priorities and future plans.
    2. Assist ministries to link their budgets and performance to their policies and priorities.
    3. Provide both financial and non-financial information.
    4. Make spending proposals that represent and optimal mix of outputs, given the MDAs spending environment. And,
    5. Commit the MDA to a given level of outputs (by providing a statement of expected outputs).

- **Step 5:** Finalization of resource allocation in line with Sector proposals and the Budget Strategy Paper and drafting the detailed budget estimates in consultation with Ministry of Finance/Planning and the Parliamentary.

B. Roles and Responsibilities

51. The roles and responsibilities in preparation of the detailed annual budget in the Ministry involve:

- **MTBF Committee:** This is the Committee in the Ministry that is responsible for formulation and preparation of the Ministerial/Departmental budget proposals. It is generally headed by the Heads of Finance, Planning, Accounts and other co-opted Heads of Departments. It is the responsibility of the MTBF Committee to:

    i. Determine final program ceilings; and,
    ii. Ascertain that the detailed annual budget proposals are in line with the Ministry Public Expenditure Reviews (and, Sector Working Group / Budget Strategy Paper decisions).

- **Head of Finance:** The appropriate Budget/Finance Director should review programs' annual budget proposals for economy, efficiency and internal consistency. The Finance Officer also engages with the Ministry of Finance on the detailed annual estimates.

- **Head of Planning:** It is the responsibility of the Head of Planning in the Ministry to assist the Chief Finance Officer in reviewing the annual budget proposals so as to ensure that they are consistent with the overall government strategy and also to provide the necessary analytical work to support the decisions of the MTBF committee on the priorities of the Ministry for funding

- **Heads of Cost Centres:** It is the responsibility of various cost centre heads to develop detailed annual budget estimates within their final ceilings and in line with their PER submissions (and, Sector Working Group and Ministry of Finance decisions), as reflected in the Budget Strategy Paper.

C. Sector Ceilings and Guiding Expenditure Planning

52. The limited resources in the budget calls for choices to be made among competing needs. The process of setting ceilings consists of two sub–processes:

1. The preparation of an economic and fiscal update referred to as Macro Economic Framework; and,

2. The setting of sector and ministry level ceilings.

1. Sector Ceilings and Guiding Expenditure Planning

53. In setting the macro economic framework the following factors are taken into consideration.

(i) The projection of economic growth targets in the medium term. Providing the economic and fiscal outlook is a challenging task. This process entails an update of all expected imports and exports, projections of investments and consumption. In working out the growth targets, consideration is made of the government's long term policy concerning wages, investment by government and other long term policies relating to other sectors of the economy. Hence the growth projections are also consistent with planned aggregate spending by Government.

(ii) Once the growth targets are identified then the Ministry of Finance (MoF) is able to project the revenue targets that are consistent with the growth targets. The share of the various targets of revenues is also guided by the projections of the growth of various sectors, for example the expected realization of import taxes is guided by the assumptions in the growth of imports in the macroeconomic model. The prevailing policies on other issues are also taken into consideration in projecting the revenues from domestic sources.

(iii) The other variable is the assumptions on private sector credit. Depending on the assumptions made on contributions by private sector to domestic investment and growth targets, the level of change in private sector credit is determined. The tradeoffs made while deciding on this variable include the level of government credit that will be targeted.

(iv) The Government credit level which is also referred to as domestic borrowing is a variable taken into consideration. The guiding principles in deciding or determining the level of domestic borrowing is the government's own policy on public debt.

(v) The other key principle strategy is inflation rate and the rate of interest. Assumptions are made on the interest rates of government securities as well as setting targets for inflation for the year and the medium term.

54. The Macro-Fiscal Framework also contains the aggregate expenditures levels. The main categories of public expenditures are recurrent (operations and maintenance) and development.

55. There are two categories of recurrent expenditures: non-discretionary and discretionary expenditures.

1. The ***non-discretionary expenditures*** are those expenditures that are pre-determined by law. These expenditures which include, other principal repayment of public debt, payment of interest on debt, pensions and consolidated fund services, such as, salaries and wages for constitutional officeholders. These expenditures are also known as mandatory expenditures. Since they are pre-determined by law, they are simple to estimate and cannot be part of a trade-off process. They are therefore just deducted from the overall resource envelope as a first charge.

2. The ***discretionary expenditures*** are those expenditures used by various agencies to produce goods and services for the citizenry. These expenditures are not pre-determined by law but by Government policy and resource availability. Most recurrent expenditures are accounted for in the recurrent budget and most capital expenditures are accounted for in the Development budget. A key policy decision

is the trade-off between recurrent and development expenditures. The desire for the growth dictate that as much as possible, expenditures be oriented towards pro-growth development programs.

2. Criteria for Establishing Sector Ceilings

56. Ceilings are determined by the available resources as determined by the Macro-Fiscal Group. The ceilings for the sectors are determined on the basis of Government Policy and priority attached to each Sector. The following are the main considerations:

- The national objectives to achieve enhanced economic growth.
- The requirements of core poverty programs;
- Funding on-going programs
- Other financial commitments through project loans and grants.

57. The first step is to review individual Sector Reports, containing Ministerial budget proposals and arrive at an assessment of resources required by the sector. For the Development (Investment) Budget, the Macro-Fiscal Group first assesses forward commitments for externally financed projects and programs and for on-going domestically financed projects. Secondly, the Macro-Fiscal Group assesses new project proposals against policy priorities together with current commitments through project loans and grants and the commensurate counterpart funding. The total is put against a sector's account as a floor since this represent ear-marked sector funding on the revenue side.

58. On the recurrent side, the process involves the determination of non-discretionary expenditures and the wage bill for all the Ministries and required operating expenses. The final process is to add up all sectors funding requirements and comparing them with available resources and making trade-offs between sectors in the discretionary, non-core poverty program and non-committee portion of budget proposals.

3. Making Tough Choices

59. This section examines the main instruments and institutions in the Iraqi budget process that ensure that available resources are reconciled with competing demands. It describes a two-phased process which provides forum for trade-offs and ensures that guidelines are followed while making budget decisions for resource allocation.

60. The process involves the setting of Sector Ceilings as contained in the Budget Outlook Paper document. The Budget Outlook sets the resource framework for the multi-year MTBF period and the national policy priorities. The bottom up process involves the compilation of Ministerial Public Expenditure Reviews (PERs) and various Sector Working Groups reports. The PERs provide the analysis of past expenditure trends and their outputs. The two levels of the process have sets of activities that produce outputs required for the decision making.

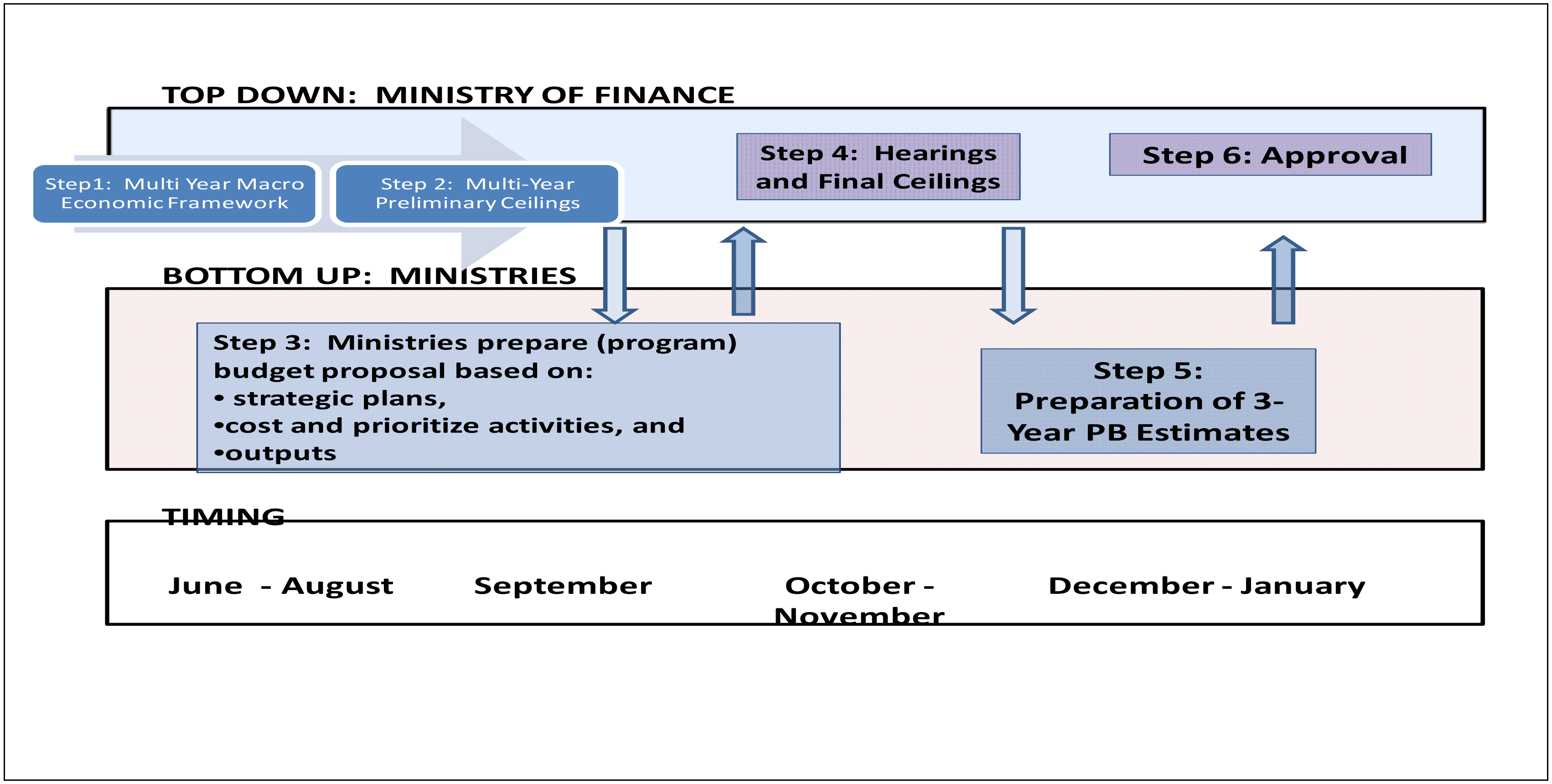
D. Top-down and Bottom-Up Budgeting Approach

61. **There are two basic phases in the budget preparation cycle**. Under the Top down approach derived through preparation of the Preliminary Printed Estimates or Medium Term Budget Framework (MTBF) – (see Figure 7, below). The aim is to:

- Calculate available funds in the next and following two years (domestic and donor funded);
- Select most important priorities of the national strategy that can be financed from the available funds; and,
- Establish budget ceilings.

62. **The MoF collects needed information from line ministries: asking for the most important priorities, how they link with the national development strategy and what is the estimated cost of implementing Ministerial priorities.** To provide this information, ministries need to prioritize their budgeted activities.

Figure 7: Proposed Iraq Budget Process



63. **The second part of the budget preparation cycle is the bottom-up preparation of the detailed National Budget**. The MoF may issue a circular requesting a line-ministry to prepare detailed budget calculations for selected priorities and within given ceilings. For these submissions line ministries will have to prepare detailed budget calculations. Upon receipt of detailed budget submissions, the Budget Department will analyse these submissions and discuss them during the Budget Hearings. Based on the outcomes of Budget Hearings, a Draft National Budget will be compiled for Cabinet's review and consequent Parliament approval.

E. Institutions, Structures and Instruments of Strategic Resource Allocation

64. The following are the Institutional Structures which should or have been put in place to facilitate the MTBF process

1. The Budget Department

65. The Budget Department is a specialized Department of the Ministry of Finance that should coordinate the MTBF budget process. In so doing, it issues guidelines on all matters pertaining to budget formulation and preparation and implementation.

2. The Budget Estimates Working Group

66. This is composed of officers from the Budget Department (MoF) and the respective line Ministries/Departments. The role of this group is to review the itemized budget proposals by Ministries/Departments

3. The Macro-Fiscal Working Group

67. The Macro-Fiscal working group comprises representation from Ministry of Finance, Ministry of Planning, the Iraqi Revenue Authority and the Central Bank of Iraq (CBI). This group establishes the budget resource envelope, provides guidance on macro-fiscal variables, and helps provide sector ceilings.

4. Sector Working Groups

68. **The membership comprises the Ministry of Finance, representatives from the Ministry of Planning National Development, sector ministries, and other stakeholders**. A sector working group is chaired by a main official representative from the sector. The role of Sector working groups are as follows:

- Coordinate preparation of PERs.
- Review sector objectives and strategies in relation to the overall national goals as stated in the Government Policy documents
- Identify sector priorities and programs and rank them in accordance with their relevance for national goals.
- Identify inter and intra sectoral linkages and identify sources of funding for the sector, and ensure that ministerial spending plans take proper account of the linkages.
- Analyse cost implications of policies and strategies in the sector and required prioritisation and discuss the mix and level of goods and services that will be provided within the available ceiling.

69. The sector dialogues is the process through which the MoF engages Ministries to evaluate whether Ministries' spending plans are economical, efficient, equitable and effective and what contribution the outputs will make to social, economic and developmental objectives of the Government. The process has an important role to play in holding departments to account for their financial management and economic performance, and evaluating competing claims on the nation's finances. It also affords the Ministry of Finance the opportunity to assess whether spending ministries have the capacity to implement their spending plans, and whether outputs are clearly defined.

5. Budget Strategy Paper

70. A Budget Strategy Paper is then produced by building on the budget outlook and is informed by the sector dialog and discussions.

- It contains the firmed up resource allocations.
- It provides ceilings to the Ministries.
- It contains finalized macro-economic framework, medium term fiscal strategy, financing of the deficit, available external resources and key risks to the frameworks.

V. COSTING PROGRAMS AND ACTIVITIES

71. In an MTBF budgeting process, institutions at various levels are required to match resource requirement with available funding. This is done by trade-offs and scaling down. For institutions to plan optimally, accurate estimates of the cost of activities are required. Costing therefore enables calculation of the cost of programs and activities and facilitates monitoring and evaluation of programs and projects. This section discusses the concept of costing and its application.

A. Unit Costs

72. **Unit cost mean cost of providing a service per unit of output.** Thus one would calculate the cost per learner, per occupied hospital bed or per outpatient, per passport issued, per passenger mile and so forth. One of the main challenges in the determination of unit costs for public programs is that unit costs can either be actual or normative. The actual unit cost means the cost of service divided by the number of beneficiaries serviced, or actual spending on public goods divided by the number of goods produced. This is a useful calculation for forward projection of baseline spending.

73. **Normative cost refers to how much it costs per beneficiary service or goods delivered. Normative cost calculations are used in the public sector as a benchmark for efficiency analysis and for assessing the adequacy of a given budget**. Normative unit costs involve *value judgments* as to the types of required inputs and level of quality and should therefore be carefully evaluated before it is used.

B. Cost Driver

74. A cost driver is a factor or an activity that drive the costs of a spending agency. In setting out a cost structure to project baseline spending. Ministries should think carefully about how different cost drivers and cost units relate. Usually there are at least two levels of cost driver to take into account.

75. Units as cost drivers. The unit chosen against which to cost an activity or project baselines are themselves drivers of the cost of a service. In the education system, the number of learners in schools drive personnel costs (more directly if learner/educator ratios are enforced), spending on certain types of goods and services such as learner support materials, utilities, transport and so forth. In agriculture the number of farms or farmers drives costs:- the more farmers there are the more agricultural extension officers are required and the more subsidies are paid out.

76. The unit to which costs will be ascribed is an important choice in any costing exercise. They should be the main and most common cost driver within a program, or a type of spending within a program. The example above of agriculture is a case in point. Whether the square kilometre surface of agricultural land or number of farmers should be chosen as the unit that drives costs depends critically on the type of service that is costed and how policies have been designed. In order to project a baseline for a subsidy spending program, land surface units may be chosen as a unit cost if the level of subsidy is determined by the agricultural land available to an individual farmer. However, if the subsidy is simply designed to deliver a standard input per farmer, the correct unit would be individual farmers.

77. Underlying drivers of unit costs. A second level to take account of is the factors that drive the cost per unit. For example, in health the type of disease and price of drugs drive cost per patient treated. In education, cost per learner is driven in turn by the learner/educator ratio and the unit cost of personnel. In transport cost per passenger kilometres is driven by fuel prices and the operational efficiency of vehicles.

78. A useful distinction can be made between *structural cost drivers* and *discretionary cost drivers*.

- **Structural cost drivers** in the public sector are those that are determined externally or are 'demand' driven. The demand for school places may vary on account of factors outside of government's control. In doing baseline projections, the forward cost of a current policy (or activity) should take into account changes in costs due to changes in structural cost drivers.

- **Discretionary cost drivers** are those that are present because of choice, such as policy specifications. For example, the number of learners in schools is also the result of school fee policies and drop-out and repetition rates, which are much more in control of government.

1. Variable Costs

79. Variable or direct costs are those that vary wholly and proportionately with an increase in output. In health there are for example, a number of variable costs: drugs, X-rays, sterile packs and meals all increase directly in line with the number of patients. In education, learner support materials are a pure variable cost. In public works construction, material used is a pure variable cost that relates to square meters constructed.

2. Fixed Cost (or Overhead) Costs

80. Fixed costs remain unchanged as an output or activity increases or decreases. Fixed costs in hospitals are the maintenance of the building and the cost of cleaning services. It is useful to note that some fixed costs are fixed to the Ministry as a whole, for example the cost of running a Minister's office and the cost of the central administration and of policy development. Within programs there may be further fixed costs, such as the cost of maintaining agricultural extension offices in an extension program.

3. Semi-Variable Costs

81. Some costs contain a fixed element as well as a variable element. Good examples are the rental of capital goods, where a fixed rental may be combined with a service charge for each unit of use. Within a hospital laundry cost is an example. There is a fixed component that relates to the infrastructure and personnel costs, and a variable component related to water, power, detergents etc. Whereas the first element remains fixed no matter how many patients are in hospital, the second increases with each additional patient added.

82. Some costs are strictly not fixed nor variable. Whereas they may not increase for several or many units of output, they also do not remain constant no matter what the level of output. A good example is personnel cost in education: with a learner/educator ratio of 30:1, personnel costs do not increase with every additional learner, but only with every 30 learners who join the system. Hospital administration services can be similar example: whereas the cost remains fixed with the addition of every one additional bed, when another 100 beds have been added an additional administrator may need to be appointed.

4. Relevant Costs

83. Relevant costs (and relevant revenues) are those that will change on account of a specific decision. This is an important distinction for costing in the public sector:- when assessing the cost of a new spending proposal the only costs that should be taken into account are those that are relevant. If there is a choice between two policy options, the only costs that need to be considered to inform the decision between the two, are those that differ between the two.

C. Projecting Baseline Spending

84. Baseline spending as described in the Annexure xx identifies minimum resource requirements assuming no change in policy. In Iraq five elements are included in baseline spending:

- The existing recurrent cost of the program, including spending on personnel, and on goods and services.

- The projected cost of transfers and subsidies, including transfers to households, individuals and institutions.

- The projected costs of major on-going domestically financed capital investment projects and of new projects which are at an advanced stage of appraisal and are close to having financing approved.

- The projected costs of on-going externally financed programs and projects where the resources flowing into the budget cannot be transferred to alternative uses. The projected cost should include both external resources and the domestic counterpart funding.

- The projected impact of pending bills from previous years on the current budget year.

85. In preparing baseline projections, Ministries should treat each of these separately, disaggregated by program.

- **Base year and first year of projection**: In an MTBF budget, a base year must be chosen. It is desirable that the base year be the last completed financial year with the current year being the first projection year. However, if accurate financial or key non-financial data are not available for the last completed financial year, \Ministries will need to use the last year for which accurate financial and non-financial data is available. It should be kept in mind though, that the further back the base year, the more likely it is that errors of estimation would have a significant effect on the forward years, since errors in the base are often progressively amplified as years are added. In the Iraqi situation, the base year is always the current year of implementation. The first forward year becomes the first year of the MTBF budget.

- **Checking against current year**: Using the last completed financial year as a base year means that the current year of implementation can be used as a first check on the accuracy of the baseline projection. If the projected financial out-turn in real life differ significantly from the baseline projection, and if it cannot be ascribed to overlooked policy changes, then there is an error in the baseline projection.

1. Factors to consider when developing base year projections

- **Changes in discretionary cost drivers:** There are significant policy changes which are not present in the base year, but which are already impacting on the current year. These policy changes should be included in the forward projection because they represent decisions that have already been taken.

- Changes in structural cost drivers such as pricing or an increase in demand has not been taken into account fully.

- Ensure that the unit cost drivers applied are always accurate.

2. Sequence for Constructing Baseline Projections

86. Before constructing individual program or sub-program baselines, the Ministry as a whole needs to decide how it wants to sequence the costing of baselines within the Ministry[1]. Ministry baseline projections of programs should be consistent – using for example standard costs for common items – so that they can be integrated to form a baseline for the Ministry as a whole. At the start of the process to construct a baseline, a Ministry should determine:

- Who or which structure will coordinate the development of baseline spending across the Ministry. It is important to have a central reference point to ensure that common costs are treated in a standard way.

- An initial list of standard costs that will be shared between programs and sub-programs.

- A common base year and first projection year, as well as a common projection period. At a minimum, baseline projections should cover the medium term.

- Which programs will be projected in greater detail. For some programs, such as Administration, a separate baseline may not be worthwhile constructing and it can be projected simply by adjusting for inflation to the previous year. Which programs will be costed on a program-wide basis and which at lower levels of cost categories.

- There are three levels at which programs can be costed: At the Program level, in which case the whole program will be projected forward either by establishing a cost driving unit, establishing a cost per unit and projecting forward the cost using the expected number of units x the unit cost, or by simply projecting the program forward using expected price increases or as a ratio to another program.

- Sub-program level; in which case the sub-program is costed as a whole using one of the two alternative methods.

    - Costing a program as a whole or partly by costing sub-programs as units. This is likely to be more robust than just costing the whole program as a unit, simply because using units that are suitable to sub-programs is a finer instrument than using a single unit for the whole program.

    - Below the sub-program level: 1) One option is to break the sub-program down into the economic categories of spending, which are then separately, projected

[1] Please see "Iraq Program Budget Manual" for greater understanding of program budget structure.

using either of the two alternative methods; 2) A second option is to combine economic categories of spending that are driven by the same unit. In primary education for example, a sub-program of school support may use the number of learners as a unit for determining personnel, materials and supplies and transport costs, while projecting maintenance costs using the number of schools or just by inflation; and, 3) Another is to develop a comprehensive and complete set of activities for the sub-program and project forward the cost of each of the activities.

87. **Once these decisions have been taken at the level of the ministry, constructing baselines for each program can begin.** This task is best broken down into:

- First projecting personnel spending, spending on goods and services and spending on transfers, entitlements and subsidies by the relevant spending category.
- Secondly, projecting spending on domestically financed capital items by program or sub-program.
- Thirdly, projecting the forward cost of earmarked externally funded program spending by program or sub-program, including the requirement for counterpart funding.
- Construction of baseline is detailed in the Annexure xx.

3. Costing New Spending Proposals

88. **New policies, new programs and activities that Ministries want to undertake comprise new spending proposals.** The following are steps taken in costing new spending proposals:

STEP 1: Allocate the projects to the Program or Sub-program under which they will be funded.

STEP 2: For each spending proposal, identify the inputs that will be required.

STEP 3: Assign the inputs and activities to economic categories**.**

STEP 4: Calculating costs. At this point each activity can be costed against the economic category of spending from which a particular cost will be funded.

Table 2: Budget Activities - Input Table

SUBDIVISION	Activity 1	Activity 2	Activity 3	Activity 4	Activity 5	Activity 6	Activity 7
	Human Resources	**Workshops for**	**Providing Cluster centres**				
RECURRENT BUDGET							
Personnel spending	Staff at cluster centres						
Goods and services		Transports & Subsistence for workshops	Materials for cluster centres Utilities for cluster centres				
Transfers and subsidies	None	None	None				
Operational budget capital expenditure			Furniture				
CAPITAL BUDGET							
Personnel spending							
Goods and services							
Transfers and subsidies							
Capital spending			Building cluster centres				

Table 3: Matrix Template for Costing New Spending Proposals

Activity Name				Activity Description and motivation				
	UNIT COST	**Quantity Year 1**	**Quantity Year 2**	**Quantity year 3**	**Projected cost Year 1**	**Projected cost Year 2**	**Projected cost Year 3**	**Description of inputs that drive costs**
RECURRENT BUDGET		**A**	**B**	**C**	**Unit cost x quantity A**	**(Unit cost + inflation) x quantity B**	**(Unit cost + inflation) x quantity C**	
Personnel expenditure								
Goods and Services					0	0	0	
Subsidies and Transfers					0	0	0	
Acquisition of capital assets					0	0	0	
TOTAL RECURRENT BUDGET								
DEVELOPMENT BUDGET								
Personnel expenditure					0	0	0	
Goods and Services					0	0	0	
Subsidies and Transfers					0	0	0	
Acquisition of capital assets					0	0	0	
TOTAL DEVELOPMENT BUDGET								
TOTAL					0	0	0	

VI. BUDGET STRUCTURE CLASSIFICATION

89. This section discusses the principles of classifying public budget and financial information, and, standardized international frameworks for structuring budgets and classifying transactions. The discussion and introduction of a new economic classification and a programmatic classification and approach to budgeting is largely left to a companion manual on Program Performance Budgeting[2].

90. A sound budget structure and classification system is the cornerstone of a good public finance management system. A comprehensive budget structure ensures that all sources of and claims on public funds are considered together, making clear distinctions between different levels of government control. A sound classification system ensures that there is consistency in how financial information is recorded across all of government's operations. A budget structure and classification system that complies with international standards is also important for internal and external transparency and standardization. It enables comparisons within the system and internationally, using standardised funding and spending categories.

91. Iraq is in the process of gradually reforming how its budget is structured and classified. The purpose of the reform is to move from a shallow poor and disaggregated coverage to more comprehensive coverage and classification that:

- Covers all government's fiscal operations;
- Provides consistency in the treatment of transactions and financial information across the system;
- Allows planning, controlling, monitoring and evaluating; and,
- Allow spending comparison internally and internationally.

92. Budget should be properly classified and coded. Budget coding should be compliant with the international standards (e.g., Government Finance Statistics GFS). A well coded and classified budget facilitates monitoring and evaluation, reporting, analysis and comparison. Three questions are relevant when allocating funds, controlling their use and monitoring;

- Who will use (or have used) funds?
- For what purpose will it be used (has it been used)? And,
- What are the expected outputs.

The budget classification corresponds with each of these questions:

- **Administrative (Organisational or Institutional) Classification**: For accountability purposes, it is important that expenditures are classified according to whom is responsible. A sound administrative classification will identify which departments or agencies is responsible for a spending item. This structure allows for the determination of who will be responsible for spending and accounting for funds. A well-developed institutional classification will comprehensively cover all government

[2] See Iraq: Program Based Budgeting Manual (2012).

entities to match accountability needs, and to reflect the hierarchical nature of relations within government, allowing for progressive consolidation of budgets and accounts.

- **Functional and Program**: Two distinct (but often related) systems are used to provide information on what the purpose of government spending is. A *functional classification* organises government activities according to their purpose (agriculture, defence, education, intergovernmental transfers, etc.) and is independent from the government's organisational structure. A functional classification provides for the analysis of the allocation of resources among sectors and is important for monitoring macro budget policy objectives (for example whether government is investing sufficiently in human resource development across various Ministries). A stable functional classification is necessary to produce historical trends of government spending and to compare data across several fiscal years. Many countries have implemented the United Nation's Classification of the Functions of Government (COFOG) as the standard functional classification which facilitates international comparisons. A *program classification* assigns funds to and traces individual costs back to government's objectives.

- **Economic, Standard Item Classification:** Classifying expenditures according to economic category is necessary for economic analysis; for example, eco*nomic classification allo*ws for a determination of what proportion of government spending constitutes wages, or the level of public capital investment. This is crucial for policy formulation. Most countries have adopted at least a Government Financial Statistics (2001) GFS-consistent economic classification system. For budget management purposes, standard item classification is critical to closely track inputs.

A. International Standards of Budget Classification

93. **The GFS system is a comprehensive conceptual and accounting framework for analysing and evaluating fiscal policy, especially the economic performance of government and the broader public sector.** It incorporates the economic and functional dimensions of government classification described above.

94. **The framework is based on best international practice and universal economic and accounting principles on the *recording of transactions*, other economic flows and classification of stocks of assets and liabilities.** In order to provide comparative data between countries on what resources are spent on, the GFS framework incorporates the UN standard on the classification of functions of government (COFOG). The GFS system of classification enables financial data to be arranged both by the economic nature of transactions and the government function that the transactions affect (for example social services, general government services etc). The GFS system allows government to account for the flow of funds by economic and functional categories of spending over an accounting (or budget) period, and provides a balance sheet at any one point (usually at the beginning and end of an accounting period).

B. Link between Budget and Accounting Classifications

95. **An integrated budget classification system is indispensable for linking budget preparation, budget implementation and financial reporting**. The categories used for

allocation of funds should correspond closely to the categories used to approve funds for spending and for accounting for those funds. Experience with budget reforms across the world has shown that there is little use in introducing reforms to the categories used for allocation without also introducing the same reforms to the Chart of Accounts.

96. In a well-developed system the Budget Classification corresponds to the Chart of Accounts, except that the latter is further desegregated for financial reporting and statistical purposes. The Budget Classification system is therefore an important instrument for control of the use of funds and reflects how funds are allocated and approved.

C. Introducing a Program Classification

97. A program classification of the Iraqi budget will be critical in moving to a program based budgeting system. Government is undertaking a gradual transition to program based performance oriented budgeting and management in order to facilitate prioritization between objectives, increase efficiency in administration and enhance the quality of goods and services produced by publicly financed institutions. A suitable first step in this process is the introduction of a program classification, through which government activities – and their associated expenditure – could be categorized according to the intended outcome or policy objective. Please see "Iraq Program Budget Manual (2012)" for further details.

ANNEXURE A: DETAILED FISCAL FRAMEWORK

98. The fiscal frame work provides a forecast of government sources of revenue expenditure and financing. The description that follows relates to the elements of the fiscal framework.

Source of Domestic Revenue

99. The government's primary sources of revenue are taxes and user fees levied for various government services. The following are common sources of tax revenue:

- Tax levied on individual's income and corporate income;
- Import duty: these are levied on the values of imports;
- Tax on the sale of goods and services;
- Investment Income: These are dividends received from government investments; and,
- Other sources of revenue include: fees, levies and licences

Total Expenditure and Net Lending

100. Expenditures are categorized either as recurrent or development.

- Interest payment:- This category includes interest payments for domestic and external debt.
- Wages and salaries:- This includes the wages and salaries for Government employees.
- Pensions:- This category includes the retirement benefits for the Government employees. The basis for the estimates is the data submitted by the pension department which is calculated on the basis of existing payroll and the projected retirees for the years of the plan.
- Others:- These include all other expenditures such as operations and maintenance and subscriptions.
- Development and net lending:- Expenditures under this category are for development programs and projects.
- Net lending is another category under development expenditures:- This is the payments by government on behalf of State Corporation arising on account of non-payment or inability of the corporation to raise resources. Its projection is based on actual information received.
- Other expenditures:_ These include contingency and budget reserves.

Financing

101. This part has the following components: Net foreign financing, privatization proceeds and domestic borrowing.

- Net Foreign financing. This includes project loans and budget support.
- Privatization proceeds arising from sale of state corporations.
- Net domestic borrowing: These are funds borrowed domestically and the amount to be borrowed is set in the budget policy document.

ANNEXURE B: CONTENTS OF A PUBLIC EXPENDITURE REVIEW

102. A typical MPER contains the following elements:

- **Foreword**. The foreword comprises a statement on the outcomes of ministerial expenditure, as evidenced by the PER, and on key priorities for the future; how these will be met; and how that is demonstrated in the document. The statement serves the purpose of making clear the intent of the Ministry – as a public service institution – to deliver the programs as proposed in the document.
- **Executive Summary.** The Executive Summary is a concise statement of the document contents, extracting for the reader the Ministry's key objectives and expenditure focuses, the most important issues arising from the analysis, and the key trade-offs made in linking spending to policy priorities.

The Main Document

103. The main body of the document should address a number of building blocks of a public expenditure review and budget proposal document. These are:

- **Explaining the purpose of the document:-** The introduction should include a statement on the purpose of the document and how it relates to previous years' PERs, as well as the subsequent documentation in the budget process.
- **Statement of ministerial objectives and priorities:-** The document needs to include a thorough discussion of the Ministry's core functions, its mission, key long-term objectives and medium-term priorities for action. It is also required to name all the parastatals reporting to the Ministry and how they relate to the Ministry's mission and core functions. The mission statement should also provide a discussion of the relationship between its programs and the National Development Plan and its medium term plan.
- **Situation analysis:-** An analysis of the spending environment of the Ministry underpins the discussion of ministerial performance and the identification of priorities. This comprises the identification of key factors in the Ministry's internal and external environment that affect spending. For example, in agriculture, a drought may affect short to medium term priority setting. A useful way of approaching the analysis for this section is working through the Ministry's strengths and weaknesses and opportunities and threats in the external environment.
- **An analysis of income**:- The document needs to include an overview of the volume and distribution of all sources of income for the Ministry, including external resources, extra-budgetary funds and appropriations- in-aid in addition to its share of the development and recurrent budgets.
- **An analysis of past spending trends**:- It is important that the Ministry takes account of its past financial performance. While this can be done at different levels and against several dimensions, the paper should not include a detailed discussion at each level of every dimension. It should rather choose areas for detailed analysis and discussion. However, in order to choose the areas for discussion, it is necessary for the Ministry to do a full analysis.

- **Benchmarking financial performance against non-financial data**. While an analysis of the past financial performance is important, it is only fully meaningful when accompanied by an evidence-based discussion of *effectiveness* and *efficiency*. This means relating spending numbers to non-financial information on beneficiaries, outputs and outcomes and providing a thorough overview of ministerial performance against its output and outcome targets. The document needs to identify core outputs, given the functions of Ministry, and related performance indicators and discuss trends in outputs for the period under review.

Annexure C: Expenditure Planning and Setting of Sector Ceilings

104. Public sector budgeting is a complex task that is best broken down into a series of focused steps, each of which serves to determine a critical financial building block towards a complete budget. This process revolves around a set of central budgeting concepts that are indispensable to a sound budget process and which will always form the basis of any budget discussion between the provider of funds and those who use the funds. Standardised use of these concepts plays a critical role in bringing accurate information in usable formats to decision-making forums.

Ceilings

105. We can only spend the resources that are available to it, notwithstanding whether it is from domestic tax revenue, external grants or borrowed funds. This creates a hard budget ceiling. A budget becomes real when it needs to take into account this real budget constraint.

106. More traditional budget systems work with a soft budget constraint in the initial phases of planning; allowing expenditure needs to play a strong role in determining the overall level of allocation. Traditional budget systems such as these are often associated with low budget credibility and high incrementalism. In the absence of hard, real budget ceilings up front, actors at various levels can afford to avoid or postpone tough trade-offs and cope with interest-group pressure by taking ongoing spending for granted and continuously adding new spending requirements. As a result, the real budget constraint only comes into play during the spending year. Ceilings only become a reality when there is no cash available during the spending year. As a result, actual budget outturns deviate significantly from planned outturns, both at the level of budget aggregates and in terms of the distribution of spending.

107. An MTBF approach to budgeting brings real ceilings into play much earlier in the process, in order to improve budget credibility, avoid crisis management and force actors to take the tough decisions when more options are still open. Three ceiling concepts are relevant to the Iraqi budget process.

- **Indicative ceilings**: Indicative ceilings are the reference point against which sectors, spending ministries and spending units start planning every year. In Iraq, indicative ceilings for the first two years of the medium term will be *rolled-over* previous years' forward MTBF allocations, at all levels of spending. They are therefore constrained to the previous years' last macro-economic forecast and fiscal framework. The second outer year is added at the start of the budget process, in line with the first updated macro-fiscal framework. A tough task is for spending ministries to determine internal indicative ceilings to spending programs and sub-programs. Indicative ceilings however are not final. Two factors may cause indicative ceilings to change:

    1. **Firstly, an indicative ceiling may change because at the aggregate level, more or less resources may become available**. This will be as a result of an adjustment to the macro-economic projections or the macro-fiscal framework. In a growing economy, higher growth for the budget period than previously

expected would mean that additional resources are available without a change to fiscal policy. A slow-down of growth will mean that fewer resources are available and ceilings may be adjusted downwards, unless a change in fiscal policy allows the tax burden on the economy to increase, or higher borrowings are feasible.

2. **Secondly, ceilings at any level may change during the budget process because of a strategic decision.** Even if the overall level of resources remains constant, the distribution of resources may change. Within a ministry, the decision may be to seek savings in one program, to fund critical services in another program.

108. **In both cases, the quality of budget submissions plays a critical role in determining how additional resources or shortfalls will be distributed across ministries, within ministries and within programs**.

- **Evolving ceilings**: At the national level, Kenya has a two-phased budget process. This means that Ministries get the indicative ceilings first through the sectors and this sets a reference point for ministries to prepare realistic budget proposals. The second set of formal ceilings is issued in the Budget Strategy Paper and follows on a sequenced budget process and represents the final ceiling within which Ministries must prepare detailed estimates. However, in reality smaller cycles occur within the process and the Ministry of Finance may issue Ministries or SWGs with adjusted indicative ceilings, mainly because of adjustments to the macro-fiscal framework. In such a case, the reiterative process generates what is called evolving ceilings, the limits on spending that occur between indicative ceilings and the final ceiling, and which reflect minor adjustments, which are in the interest of Ministries or the overall system to communicate earlier, rather than later.

- **Final ceilings**: A final budget ceiling is issued to Ministries in the Budget Strategy Paper. This occurs after the Ministry of Finance, through the Sector Working Groups, has heard Ministry's defending their existing budgets and asking for additional resources. Chapter 3.2 sheds light on how these inputs combine to provide final Ministry ceilings. At the level of Ministries these ceilings should translate into final ceilings for programs and sub-programs, within which final resource-constrained spending proposals can be prepared.

Floors (Baseline Spending)

109. **Floors are the opposite of ceilings and indicate a minimum amount of resources that should be spent on a specific area or activity.** Setting floors are usually associated with policy objectives: for example the Ministry of Finance may require a minimum percentage of the education budget or a minimum amount equal to the expected requirement to be earmarked for learner support materials in primary education. Floors can be utilized as a budgeting instrument by either the Ministry of Finance, or by central management of sector ministries

Baseline Spending:- Adjustments for New Spending Proposals

110. A budget is made up of three sets of broad spending criteria:

- **Firstly there are the sum total of activities that are continued from the previous year.** These are activities that have been decided on at some point in the past and the funding of which will continue unless it is challenged. The sum total of the forward cost of continuing all activities at current levels into the future is known as a spending *baseline*. Calculating the spending baseline means estimating how much it will cost a Ministry to deliver goods and services within current policy parameters into the future, taking into account changes in the outside world.

Figure 8: Spending Baseline

A **spending baseline** is the forward cost of delivering a Ministry's services assuming no change in policy, but taking into account cost factors that change in the outside world, such as price increases or an increase in the demand for a service.

- For example, if heavy rains are likely to increase the risk of malaria and government has a policy to provide malaria prophylaxis free of charge, the increase in number of treatments provided, should be costed in the baseline.

- If a price increase is expected in treating each individual patient on account of higher personnel costs and an increase in the price of treatment, this additional spending should also be costed in the baseline.

- **Secondly, Ministries can make *adjustments* to the baseline that are not the result of new policies, programs or projects, but represent a change in the level of services or goods provided**. For example, if the value of fertilizer subsidies is increased on account of a policy decision by government, this would represent an additional cost on account of a change in policy, and should be calculated *in addition to* the baseline.

- **Thirdly there is the cost of activities that are being undertaken for the first time and are the result of a decision in the budget process to fund a new policy, a new program or a new project.** For example, if Ministry of Foreign Affairs decides to develop a service that allows citizens to apply for passports on line, the development cost and recurrent cost of running the service over the medium term would represent a new policy proposal which should be costed as an addition to the baseline

111. We can collectively describe the last two types of spending as *new spending proposals*. In a MTBF budget baseline spending, plus adjustments and new spending proposals need to fit into the spending ceiling.

Savings

112. If the sum total of baseline spending, plus adjustments and new spending proposals of any spending unit at the level of a Ministry, or a program or sub-program will be more than the resources available, then there is a need to look for savings. Savings can be the result of efficiency savings, or on account of discontinuing or scaling down lesser priority activities.

113. **Efficiency savings** are generated when a ministry (or a unit of a ministry) finds a cheaper way to deliver the same outputs, or a different set of cheaper outputs to deliver the same policy effect. With technology improvements, efficiency savings are usually possible. In order to scale down or discontinue activities Ministries need to undertake an assessment by program, and determine which of the activities contribute more to current policy objectives, and that have low priority.

114. **An MTBF budgeting system utilizes budget submission formats, at the central Government level and within ministries, which requires spending proposals to be made within a hard budget ceiling, broken down into the forward cost of existing spending activities and new spending proposals**.

Figure 9: MTBF Versus Zero Based/Other Reforms

A key difference between MTBF approaches to budgeting and other reforms such as zero-based budgeting aimed at countering a default to incremental budgeting, is that an MTBF approach accepts that:

- **A large part of budgeting will always be incremental**, since it is not possible within the space of a budget process – given time and human resource constraints – to approve every bit of spending anew.
- **The focus should be on minimizing the part that is done on an incremental basis,** and maximizing the part that is deliberately re-directed towards current policy priorities.
- **An MTBF approach utilizes hard budget constraints, budget submission formats, good information and sound processes to create a large enough margin on the bulk of spending within which reprioritization takes place.**
- By planning over the medium term, the system creates long time horizons to achieve savings on spending that is often rigid in the short term, such as personnel spending.
- In traditional annual budget systems, such short-term rigidity means that the budgeting base cannot be adjusted significantly, and rolled over as given from year to year.
- In a programmatic MTBF, the focus shifts from input line items to programs, sub-programs and activities, adding to the strategic value of the budgeting system.

Earmarking and Ring-Fencing Funds

115. The two concepts that are frequently used in allocation and use of resource against policy objectives are **earmarking** and **ring fencing.**

- **Earmarking** refers to the pre-allocation of resources for specific spending purposes. Earmarked resources are therefore part of a Ministry or program's revenue, but cannot be reallocated for any other spending purpose, except the indicated purpose. Earmarking is strongly associated with donor resources, which come to Ministries and programs for use, but are tied to specific objectives or specific activities. Extra-budgetary funds are also a feature of earmarking. Conditional grants used by national government for implementing activities in local government, or through public sector entities outside of the central government, are effectively also a form of earmarking. While earmarking resources is an effective budgeting tool to protect priority spending items, they also trap resources against activities and can prevent efficiency savings from being made.

- **Ring-fencing** refers to:

    i. The practice of protecting certain types of spending against cuts during or before the spending year. While resources for ring-fenced spending is not officially earmarked and are allocated out of the general pool, ring-fencing the spending implies that it would be the last spending to be affected by resource cuts.

    ii. In an inverse use of ring-fencing, it refers to the practice of demarcating certain types of spending so that overruns under this spending, does not affect the rest of the budget but constitute borrowing from the next year's allocation for the spending.

Getting Budget Decisions Right: Budget Submissions and Resource Ceilings

116. The format in which information is requested from spending units is a critical determinant of the quality of decision-making. Also, how relevant ceilings are to policy priorities are in turn crucial for spending outcomes. The principles discussed here reflect information provided in earlier sections dealing with Ministerial MTBFs and PERs, on processes to set ceilings, and processes to match ceilings and spending proposals.

Establishing Resource Ceilings

117. The methodology described here is relevant to two aspects of the Ministerial MTF process:

> **Step 1: Determining the overall sector resource ceiling -** A first step in setting ceilings requires ministries to calculate the total amount of resources that is available to the Ministry, including both domestic and external resources. The table on the next page provides a guideline for calculating resource ceilings, and the guiding rules to be used to estimate resources at two critical phases in the Ministerial MTBF Budget process: firstly when preparing a draft Ministry Public Expenditure Review; and, secondly, when allocating the final resource ceiling provided by the Ministry of Finance, between the programs of the Ministry.

The following important aspects should be noted:

- **The assessment of available resources to be comprehensive.** That means that resources that are flowing to public entities attached to the Ministry should also be included. This will be balanced on the expenditure side by a calculation of baseline expenditure obligations attached to public entities. However, including public entities into an assessment of Ministry resources and spending helps expose the trade-offs that are made between spending on activities through public entities and spending on core Ministry activities.

- **It is important that only certain resources are included.** As at the central level conservatism in resource estimation is crucial to ensuring that what is planned on the expenditure side, will be implemented.

- **A split is made between resources that are for general allocation, that is, not earmarked and resources that are earmarked and therefore not available to fund new, hitherto unfunded Ministry priorities**. It is important to make this split both on the revenue and expenditure side, to get an accurate picture of the resources that are available for allocation.

Table 4: Calculating Available Resources for Ministry Programs

Type of Revenue		Budget Year	Projected Year - 1	Projected Year -2
Resources available for allocation				
Revenue from Main Revenue Fund for Recurrent Budget (minus earmarked funds)	For first draft MPER	Rolled over from previous year allocation	Rolled over from previous year allocation	Preliminary amount, First Projected Year plus inflation
	For development of detailed estimates	As indicated by MoF	As indicated by MoF	As indicated by MoF
Appropriations in Aid	For first draft MPER	As estimated	As estimated	As estimated
	For development of detailed estimates			
Development Budget unallocated resources	For first draft MPER	Not applicable	Not applicable	Not applicable
	For development of detailed estimates	As indicated by MoF	As indicated by MoF	As indicated by MoF
Sector Budget Support (grants and loans)	For first draft MPER	Include only Certain Sector Budget Support	Include only Sector Budget Support that is certain; signed and will be disbursed.	Include only Sector Budget Support that is certain; signed and will be disbursed.
	For development of detailed estimates			
TOTAL RESOURCES AVAILABLE FOR ALLOCATION		A	A	A
Resources tied to specific programs				
Program 1				
Earmarked funds in general allocation from Main Revenue fund	For first draft MPER	As carried over	As carried over	As carried over
	For development of detailed estimates	As indicated by MoF	As indicated by MoF	As indicated by MoF
Earmarked funds from extra-budgetary sources	For first draft MPER	As estimated	As estimated	As estimated

	For development of detailed estimates			
Earmarked external resources (loans and grants)	For first draft MPER	Include only support that is certain; negotiated, signed and that will be disbursed.	Include only support that is certain; negotiated, signed and that will be disbursed.	Include only support that is certain; negotiated, signed and that will be disbursed.
	For development of detailed estimates			
TOTAL PROGRAM 1		B	B	B
Program 2				
Etc				
TOTAL PROGRAM 2		C	C	C
TOTAL RESOURCES ALREADY ALLOCATED		D (=B+C +etc)	D (=B+C +etc)	D (=B+C +etc)
TOTAL AVAILABLE RESOURCES		A + D	A + D	A + D

Step 2: Identifying the resource allocation implications of key ministerial policies and reforms. When setting indicative ceilings for the first time, it is necessary to take account of how key ministerial policies and reforms will affect spending across programs. Similarly, in a much more detailed manner, it is necessary to get a cross-program picture of how different programs' strategic needs weigh up against each other when final ceiling allocations are made.

118. Assessing program's strategic need involves an inter-program analysis of policy and reform priorities and their implications for resource allocations under the MTBF. This analysis can be done in a matrix format that is divided into several columns covering (see Table, Below):

- **i.** A summary analysis of current situation regarding the overall budget, program performance and resource use in the sector;
- **ii.** The program priorities and reforms for the sector;
- **iii.** The financing and resource implications of these priorities and reforms;
- **iv.** The relative priority of the sector for receiving additional resources. An example of the matrix and the information and analysis requirements are provided below.

Table 5: Format for Analysing Strategic Program Requirements

FORMAT FOR ANALYSING STRATEGIC PROGRAM NEEDS **Main Program: Primary Education**				
Current Situation	**Objectives and Program Reform Actions**	**Resource implications of reforms**	**Relative priority of the Program to receive additional resources**	**Program share in available resources**
The purpose of the column is to identify how the objectives and targets and program reform actions relate to the current situation, it should provide: ▪ Expenditure trends; ▪ The quality of service delivery; ▪ Key factors influencing service delivery; ▪ Trends and pressures – (e.g. increasing demand for the services, deteriorating infrastructure);	▪ List the expected objectives of the program for the medium term. ▪ Describe how the situation is expected to have changed by the end of the three year MTBF period. ▪ Targets may relate to: ▪ Expansion (or contraction) of the activity of the program; ▪ New activities ▪ Improvements in the quality of the service provided; ▪ Improvements in the efficiency with which the activity is undertaken. ▪ What are the processes, changes in implementation that are expected?	▪ This column should indicate what the resource implications are of key strategies relevant to the program. ▪ A useful approach is to roughly cost out key implications, utilising current spending information in the sector, or providing an outline cost of new spending activities. ▪ To assist in the costing it may be useful to list the key additional inputs, or changes to inputs that result from the priority actions.	▪ This column should be utilised to summarise the program's relative priority compared to other programs in the sector. ▪ It should look at relationship of the program to the Ministry's core functions, inter-program linkages,,relative importance and need of beneficiaries and, relationship to the overall policy priorities of the Government of Iraq and expressed in the national development plan.	

Step 3:Determining the Base Resource Ceilings for Each Program The third step involves determining the base resource ceilings for each program. The base ceiling comprises several components which need to be determined for each year of the coming MTBF period and which are costed by programs (or sub-programs) in the baseline projection:

1. **The existing recurrent cost of the program**, including spending on personnel and spending on goods and services, excluding transfers and entitlement payments such as social security payments and subsidies.
2. **The projected cost of transfers and subsidies**, including transfers to households, individuals and institutions. This includes the projected cost of entitlement payments, such as social protection and subsidies which are driven through policies that establish entitlements. Because of their significance in some programs, the costs of these spending activities are projected as a separate element of the sector ceiling. Transfers to public entities, or spending by public entities that are financed through extra-budgetary funds should also be included. All transfers should be included, whether they are capital or recurrent in nature.
3. **The projected costs of major on-going domestically financed capital investment projects and of new projects** which are at an advanced stage of appraisal and are close to having financing approved. Such commitments are particularly significant in the economic infrastructure sectors in which public investment represents the predominant share.
4. **The projected costs of on-going externally financed programs and projects where the resources flowing into the budget** cannot be transferred to alternative uses. The projected cost should include both external resources and the domestic counterpart funding.
5. **The projected impact of pending bills from previous years** on the current budget year.

119. An accurate projection of baseline spending is critical for budget credibility and integrity. While each program and sub-program is best situated to cost their own baselines, it is critical that these projections are reviewed critically at the centre. The table below provides a template for recording program baseline projections to calculate program shares in additional resources.

Table 6: Recording Implications of Baseline Spending

Baseline projection for	**Budget year**		**Projection Year 1**		**Projection Year 2**	
	To be funded from resources available for allocation A column	To be funded from ear-marked resources B column	To be funded from resources available for allocation A column	To be funded from ear-marked resources B column	To be funded from resources available for allocation A column	To be funded from earmarked resources B column
Program 1						
Personnel Costs						
Goods and Services						
Transfers, entitlements and subsidies						
Current and approved Domestically funded Capital Projects						
Externally financed projects and programs where resources cannot be transferred						
Pending bills						
Total baseline						

Baseline projection for	Budget year		Projection Year 1		Projection Year 2	
	To be funded from resources available for allocation A column	To be funded from ear-marked resources B column	To be funded from resources available for allocation A column	To be funded from ear-marked resources B column	To be funded from resources available for allocation A column	To be funded from earmarked resources B column
projection Program 1						
Program 2						
Etc						
Total baseline projection Program 2						
TOTAL FOR MINISTRY	Total amount for budget year that needs to be funded assuming no policy change from general resources available for allocation	Total amount funded from earmarked resources, should equal program specific resources in revenue table	Total amount for 1st projection year that needs to be funded assuming no policy change from general resources available for allocation	Total amount funded from earmarked resources, should equal program specific resources in revenue table	Total amount for 2nd projection year that needs to be funded assuming no policy change from general resources available for allocation	Total amount funded from earmarked resources, should equal program specific resources in revenue table

Step 4: Determining the Additional Resources Available to Finance New Spending Proposals The fourth step is to calculate the additional resources available to finance new spending initiatives across all programs in the Ministry (or, if working at the next level, across all sub-programs in the program). This step utilizes the overall resource framework determined in Step 1 and baseline spending calculations recorded by program in Step 3 above. Additional resources available to finance New Spending Proposals are determined by subtracting Column A total of the table above for each year, from the general resources available for allocation total in the table in Step 1, or the A row total in the table template provided with Step 1. Once calculated an assessment should be made as to whether the level of additional resources will allow the Ministry to tackle in a meaningful way the agenda of priorities and reforms identified in Step 2. If not, then Step 3 should be repeated taking into account possible:

i. additional efficiency savings across programs;
ii. additional discontinued activities across programs;
iii. the scope for phasing back planned increases in subsidies and social protection payments;
iv. the scope for cutting back on planned capital spending allocations.

120. Ministries should note that savings that have already been identified at the program (or sub-program) level to allocate to new spending activities at the program and sub-program level should best be left for use by the relevant units. If identified savings are utilized at higher levels to fund rival programs or sub-programs, spending units are not encouraged to make efficiency savings in order to achieve their objectives. If the prioritization agenda in the Ministry requires that some of these savings are not left at the level where they were first identified, spending units should be compensated with a return of the savings in future years out of general growth in available resources.

121. Allowing self-identified savings to remain within programs and utilizing savings identified at the central level will encourage those with better information on potential savings, to identify them themselves.

Step 5: Allocating the Additional Resources to Give the Total Ceilings for Each Sector The fifth step is to allocate the additional resources between programs (or sub-programs) consistent with the priorities for additional resource allocations that were identified at Step 2. There is no single way to determine these additional ceilings. In practice it will typically involve a combination of:

i. allocating resources for certain specific costed measures that have been identified as being of particular priority; and,

ii. providing general increases in funding levels to priority programs.

122. The role of the political leadership in the ministry in determining these trade-offs is critical. The information collected in step 2 should underpin the final decisions. The resulting total program (or sub-program) ceilings thus comprise two elements:

- **The baseline ceiling** broken down between: (i) recurrent spending on personnel and goods and services; (ii) transfers, subsidies and social protection entitlements;

(iii) domestic capital spending; and (iv) externally financed capital spending and its associated counterpart domestic spending.

- **The additional ceiling** to fund program and reform initiatives, where this additional funding is linked to the implementation of specific measures. These should be identified.

123. **Before allocating resources however, it is necessary for the centre to ascertain whether the budget submissions from lower levels represent an optimal use of available resources and whether they are feasible, given cost factors and changes in the external environment.** The table 4b identifies key sets of analysis that can be performed to check budget submissions and generate questions to be asked from program and sub-program managers/spending units.

Step 6: Distributing the ceiling between the Recurrent and Development Budgets
The final step is to split the allocated program or sub-program ceiling between spending financed through the Development Budget, and, spending financed through the Recurrent (Operations and Maintenance) Budget.

124. In drafting the final Ministerial PERs and preparing detailed expenditure estimates in the final stage of the budget preparation process, Ministries, programs and sub-programs are then required to indicate how the resource ceilings made available against each of these categories, will be used, broken down in the appropriate categories and classification systems.

Table 7: Reviewing Consistency of Program Spending

<table>
<tr><td colspan="5">PROGRAM 1: <<Name of Program>></td></tr>
<tr><td colspan="4">REVIEW OF BASELINE SPENDING AND SAVINGS TO BASELINES</td><td rowspan="2">Review of new spending proposals</td></tr>
<tr><td>Personnel spending</td><td>Spending on other goods and services</td><td>Spending on transfers and subsidies</td><td>Spending on capital goods</td></tr>
<tr>
<td>▪ What are the changes that are being proposed in terms of personnel spending in the program? Check for:
▪ Growth from previous spending year and over the medium term;
▪ Share of personnel spending in total spending of program;
▪ Change in spending per staff member;
▪ Is the provision for personnel spending adequate?</td>
<td>▪ What are the key goods and services items for the Program under review?
▪ Are trends explained?
▪ Are deviations from previous trends explained?
▪ How feasible are the trend changes proposed?</td>
<td>▪ Are there any deviations from trends on spending on transfers, entitlement spending and subsidies?
▪ In terms of growth?
▪ In terms of share of spending?
▪ Are these changes explained?
▪ Does the program expect to pay out fewer subsidies, or less per subsidy or entitlement if there is a decrease?</td>
<td>▪ What trend changes are proposed in terms of budgeted spending on capital items, albeit financed by domestic or external resources?
▪ Are reasons provided for growth (negative or out of trend positive?)
▪ What is the share of spending changes?
▪ Is the proposed spending on capital items adequate to maintain infrastructure, provide for program expansion?</td>
<td>▪ Review costing of new policy proposals for:
o Comprehensiveness
o Feasibility in terms of capacity to implement
▪ Is the costing robust, given the twin requirements of sufficiency and efficiency?
▪ Were the right cost drivers chosen?
▪ Are price estimates robust?
▪ Are all inputs accounted for?
▪ Does the costing provide a reasonable basis for allocation?
▪ In other words, will the allocation requirement as indicated by the costing be sufficient to the task of delivering on the objectives? And, on the other hand, can it be reduced?</td>
</tr>
</table>

Budget Submission Formats

125. The exact format of budget submissions to the Ministry of Finance and budget submissions to be used within ministries are determined by those requiring the information. However, budget submissions whether in the form of Ministerial Public Expenditure Reviews or separate technical documents should include a key set of building blocks. These building blocks are illustrated in earlier chapters discussing the specific instruments, but are repeated here in generic form as a guide to Ministries when designing their internal budget processes.

126. A budget submission format should contain:

- A clear statement of the overall goal of a program or sub-program
- Clear medium term objectives that are to be achieved by a program or sub-program. These objectives should be specific, measurable, attributable, relevant to the overall goal and time-bound.
- A clear statement on how the program or sub-program will be monitored to show it has achieved its objectives
- An analysis of the program's current situation. The objectives should relate to the current situation, either representing how issues in the current situation will be addressed, or targeting change or progress against the current situation towards the goal. The analysis of the current situation will include information regarding current financial and non-financial performance.
- A statement on the strategies (or reforms) that the program will undertake to address the current situation and the expected changes over the medium term.
- An analysis of the projected cost / spending that is required to reach the targeted objectives. This analysis should show separately:-
    a. A projection of baseline spending
    b. An indication of planned changes to the baseline, the net effect of (i) savings and (ii) new spending proposals.
    c. The composition of proposed savings
    d. The composition and costing of new spending proposals
- The spending analysis should be against the main budget classifications, including at a minimum the programmatic and economic dimensions of spending and a high level institutional classification.
- Output and efficiency targets against projected spending.

ANNEXURE D: CONSTRUCTION OF BASELINES

127. Construction of baselines comprise the following:

Projecting spending on personnel, goods and services and transfers entails the following steps:

Step 1: Collecting and analyzing actual expenditure data. The first step in doing a baseline projection is to collect actual expenditure data by program / sub-program, in the main economic categories of spending. While Ministries will use the current year as a basis for projecting forward baseline spending, a check needs to be done that the current year does not have outlier in terms of a longer term spending trend. The following will need to be done:

1. Tabulate actual expenditure for up to three years back, starting from the last completed financial year, by program, sub-program or main activity within a sub-program.

2. Calculate average year on year growth and shares in spending envelopes to identify spending programs, categories or items that:

    - Have behaved erratically (and therefore may require an identification of underlying cost drivers and careful forward projection); or,

    - **H**ave experienced a trend-change in the base year, and therefore may require an adjustment or careful forward projection.

The collection of accurate actual spending information against the main categories of spending is a critical step in constructing a baseline. If the quality of the actual spending data is poor, the outputs of the exercise will be equally poor.

Step 2: Deciding which spending categories will be projected and which projection method to be used:

- The next step is to list all the spending categories (whether programs or sub-programs or other categories) and determine for each which method will be used to project forward baseline spending.

- Spending categories that will be projected simply adjusting for inflation are projected first.

- The second group is those categories that will be projected by identifying cost-driving units, underlying cost drivers and price factors.

- Once these two groups have been projected, the third group of spending categories can be completed.

- This group is projected by using a ratio to a spending category that has already been projected using one of the other two methods. For categories that are placed in the third group, it is necessary first to check how they have behaved in the past in relation to the independent program to ascertain whether it is a suitable method of projection.

Step 3: Projecting inflation and applying inflation projections to bulk-costed programs

- Ministries are advised to use inflation projections from the Budget Outlook document for the medium term.
- Longer term inflation projections can be sourced from the Central Bank of Iraq.
- Once an inflation projection is in place, it is simply a matter of projecting cost against the category by adding inflation to the previous year's cost.

Table 8: Projecting by using Annual Change in the Price Index

	Base Year	**Current Year**	**Projection year 1**	**Projection year 2**	**Projection year 3**
Administration	A = actual spending in base year	B= A x (1+inflation)	C= B x (1+inflation)	D= C x (1+ inflation)	E = D x (1+ inflation)

Step 4: Projecting spending by using cost drivers and unit costs:- This entails the following:

- Analysing cost behaviour and selecting unit costs and cost drivers.
- For the second group of programs (or sub-programs or other categories) that will be projected by identifying cost drivers, the first step is to identify for each category of spending to be costed, a suitable unit that acts as a cost driver, and the relevant underlying cost drivers, as well as price information over the projection period.
- The matrix below – developed for a fictional primary education sub-program – can be used to plan the projection of spending for the three main recurrent categories of spending.

Table 9: Sample Matrix Illustrating Costing Method, Units and Cost Drivers

Program: Public Ordinary Education				Sub Program: Primary Education		
Economic Category of Spending	**How do costs in this category behave?**	**Which projection method is suitable?**	**Which unit is the most relevant as a cost driver?**	**What drives the number of units or cost per unit?**	**What data is required?**	**What structural cost drivers do we need to take into account?**
Compensation of employees	Variable	Unit x unit cost	No of teachers	No of learners, Learner/educator ratio	Enrolment projections	▪ Wages increases of 5 per cent per annum ▪ A policy is in place to increase the literacy rate by 35%.
Use of goods and services	Disaggregate into component items: see below.					
Grants, transfers and subsidies	Variable	Unit x unit cost	No of learners in subsidized schools	Ratio to no of learners in public schools	Historical educational system data to establish ratio; forward enrolment projections	Strong growth in provision of private education services may push up ratio:
Desegregation of Use of goods and services						
Utilities supplies and services	Semi-variable	30% base by inflation				
Communication	Fixed	By inflation				

Program: Public Ordinary Education				Sub Program: Primary Education		
supplies and services						
Domestic travel	Variable	Unit x unit cost	No of teachers	No of learners, Learner/educator ratio	Enrolment projections	Subsistence allowance policy changed – need to adjust actual unit cost accordingly.
Foreign travel	Inflation (not significant)					
Printing, advert & info supplies and services	Variable	Set to grow as a ratio to specialized materials and supplies				
Rentals of produced assets	Fixed	By inflation				
Training expenses	Variable	Unit x unit cost	No of teachers	No of learners, Learner/educator ratio	Enrolment projections	
Hospitality supplies	Inflation (not significant)					
Insurance costs	Step cost	Unit x unit cost	No of schools	No of learners Learner/school ratio	Enrolment projections	
Specialised materials and supplies	Variable	Unit x unit cost	No of learners		Enrolment projections	Agreed textbook policy to be implemented: adjust spending per learner progressively to achieve 1:1 ratio as per policy

Program: Public Ordinary Education				Sub Program: Primary Education		
Office and general supplies & services	Inflation (not significant)					
Fuel oil and lubricants	Inflation (not significant)significant)					
Other operating expenses	Inflation (not significant)					
Maintenance	Variable	Unit x unit cost	No of schools	No of learners Learner/school ratio	Enrolment projections	

128. Collecting non-financial information: The number of units that were serviced, or produced for the base year, needs to be ascertained, as well as for a number of years prior to the base year. This is necessary to determine a robust base unit cost. The analysis matrix above should be used to generate a list of non-financial information that is required, both in terms of the chosen units and underlying non-financial cost drivers. For many ministries information on the number of beneficiaries, outputs produced, activities undertaken may not be readily available. In such cases an effort should be made to identify proxy indicators that can be used to make an approximation of the number of units. The important factor is that the choice of units and the establishment of a base number of units should be defensible.

129. Using financial and non-financial information to calculate base unit costs and key ratios: The base unit cost is calculated by dividing the actual spending by the number of units in the base year. In cases of a semi-variable cost, two simultaneous calculations will provide a forward projection. Firstly a percentage of the actual spending can be set aside to grow by inflation, and secondly, the remainder can be divided by the base number of units, to be projected forward.

130. Adjusting the number of units forward by taking into account underlying structural cost drivers: It is necessary to project forward the number of units that need to be funded for each year of the projection period. It is important to only take into account structural drivers of the number of units, in other words factors that are outside of the Ministry's control. Any discretionary factor taken into account would be a change in the current level of service provision and should either be shown in the budget submission as a saving, or a new spending proposal/adjustment. For example, in education the number of learners that need to be serviced is determined by structural factors such as population growth rates, migration and mortality rates. Discretionary factors such as promotion, drop-out and repetition rates and school fee policies may need to be taken into account to calculate the number of units forward, but the factor used should not change from the one that is relevant to the base year unless a policy decision has already been taken and approved, to adjust these factors.

131. Adjusting forward unit cost with price information: Before projecting baseline spending in a spending category by using unit costs, the base unit cost needs to be adjusted in future years in line with known price information. Common factors to be taken into account are inflation, or known additional (or smaller) adjustments, such as negotiated wage increases, changes in policies that govern the conditions of public sector employment etc.

132. Multiplying projected number of units by projected unit costs: The projected number of unit(s) are then multiplied by the projected unit cost for each year of the projection period to get a projected baseline cost. The table below illustrates how this can be set up in a spread-sheet program for ease of calculation.

Step 5: Projecting spending categories using a ratio to other variables. Some programs, sub-programs or economic spending categories within sub-programs lend themselves to be projected by linking them to other more carefully calculated projections. The implication of this method is that costs in the spending category will change in line with changes in the other variable. In the analysis matrix a few examples of this method can be found. A good application of this method is where the underlying cost in a spending category behaves like a variable cost, but where the spending category itself is not a significant factor in program planning and implementation. Another instance of this method is the proposal to calculate spending on subsidies by calculating the projected value per subsidy multiplied by the number of subsidized learners. The decision is to project the number of learners receiving subsidies by using a ratio to the number of learners in the overall system and to research whether there is a trend change in this ratio that need to be applied in going forward.

Projecting baseline spending on domestically financed Capital Investment Projects. A next category of spending that needs to be considered to project baseline spending is capital investment projects that are financed from domestic resources. Two types of costs are relevant to this assessment: firstly the capital investment costs and secondly, the recurrent costs arising from completed projects.

Table 10: Projected Baseline Cost Matrix (Sample)

Projecting Personnel Remuneration in Primary Education						
	Base Year	**Current Year**	**Projection Year 1**	**Projection Year 2**	**Projection Year 3**	**REMARKS**
CALCULATION						
Number of learners	501,449	518,498	536,127	554,356	573,204	From enrolment projections
Number of teachers	14,969	15,478	16,004	16,548	17,111	Actual number for base year, subsequent years determined by applying actual base year across projection period
Cost per teacher	420	441	463	486	511	Result in base year of dividing actual spending on remuneration by number of actual teachers to get an average cost per teacher.
Spending (IDINAR '000)	6,287	6,826	7,411	8,046	8,735	Actual spending in base year, thereafter calculated by multiplying projected number of teachers by projected cost per teacher.
Check on Robustness of projection						
Projected actual spending in current year		6,847				
Calculation incrementally by inflation only (assuming 5%)	6,287	6,601	6,931	7,278	7,642	Under incremental line item budgeting an underestimation of the required baseline spending would have meant a 12.5 % underestimation by the third projection year.

133. Listing all relevant projects by program or sub-program A primary step in the forward budget calculation is to list all projects that:

- Are in progress and will require further financing during the projection period
- Will be completed before the relevant projection period, therefore not requiring their capital cost to be included in the baseline, but rather their resulting recurrent costs.
- Have already been approved and will be implemented during the projection period, incurring capital investment costs

134. Against each project, the need to take into consideration whether its capital cost and/or recurrent cost that should be taken into account and from which sub-program or program the project is funded. Projects that meet one or more of the criteria above carry costs on account of policy decisions that were taken prior to the projection period, which merit their inclusion in the spending baseline.

135. Determine relevant capital cost by program or sub-program. Projects on the above list that have capital costs relevant to the projection period should be costed one by one to determine the nature and extent of the relevant costs. Ministries are advised to use the methods discussed below regarding the costing of new spending proposals.

136. Determine the relevant recurrent costs by program or sub-program. Projects on the list above whose the completion will incur recurrent costs during the projection period that should be included in the baseline, should be assessed regarding the likely types of recurrent costs that will be incurred.

137. Determining the forward cost of externally financed projects and programs for inclusion in the baseline. Externally financed projects and programs that are already approved and have commenced have a net impact on the baseline when:

- They involve capital investment that lead to recurrent costs which are to be financed from domestic recurrent resources
- They involve counter-part funding from domestic resources which otherwise would not have been earmarked and would be available for allocation within the baseline, or to new spending proposals.

138. It is for these reasons that externally financed projects should be considered as a spending item in calculating ministries baselines. In addition, in line with good budgetary practices, all externally financed activities should be included in the public budgeting framework so that their contributions to the Country's economy can be assessed together with domestically financed. This also allows spending from external sources to be approved by Parliament and Ministries held accountable for achieving the planned outcomes. Therefore, in principle, externally financed projects will not be netted out in constructing baselines, but be reflected in full on the revenue side and on the expenditure side.

ANNEXURE E: BUDGET GLOSSARY

139. The following words are being used in the context of program-based budgeting and have the following meaning:

Accounting System	The set of accounting procedures, internal mechanisms of control, books of account, and plan and chart of accounts that are used for administering, recording, and reporting on financial transactions. Systems should record all stages of the payments and receipts process needed to recognize accounting transactions, integrate asset and liability accounts with operating accounts, and maintain records in a form that can be audited.
Activity	An activity is generally the smallest building block within a program that has a definable purpose and specific allocated costs. An activity is a thing you do to achieve a policy priority within a sub-program.
Audit	Expert examination of legal and financial compliance or performance, carried out to satisfy the requirements of management (internal audit), or an external audit entity, or any other independent auditor, to meet statutory obligations (external audit).
Baseline Budget	This baseline budget includes the costs of the current level of activity, which is the costs of ongoing programs adjusted for inflation services, legally mandated requirements, one-time expenditures, and the impact on a full year basis of decisions made in the current year.
Budget	The budget is generally prepared annually, and comprises a statement of the government's proposed expenditures, revenues, borrowing and other financial transactions in the following year and, in many countries, for two or three further years. The budget is submitted to parliament, which authorizes expenditure by approving either a budget act or an appropriation act that is consistent with the budget proposals.
Budgetary Unit	A Ministry or Government Agency
Capital Investment	An outlay of money to acquire or improve capital assets such as buildings and equipment.
Cash Basis	An accounting method that recognizes revenues when cash is received and recognizes expenses when cash is paid out.
Chart of Accounts	A chart of accounts provides the structure for recording and reporting of all financial transactions for a governmental unit, and classifies and determines what financial transactions can be tracked for managerial purposes and reported in the financial statements.
Core Budget	Includes all income and expenditure (including donor funds) that pass through and are administered by the Ministry of Finance (through the Treasury Single Account).
Costing	A management tool used to estimate the overall resources needed for implementation of an activity/program, assuming normal operations.
Efficiency	Measures the ratio of inputs needed per unit of output produced, measuring the extent to which resources are available for and applied targeted activities e.g. cost of vaccination program/number vaccinated.
Effectiveness	Measures the ratio of outputs (or resources used to produce the outputs) per unit of project outcome/impact e.g. the number of vaccination (or cost) per unit decline in mortality rate.
External Budget	A sub-program/activity that is funded directly from an aid donor and that financing does not go through the Ministry of Finance accounts outside the core.
Financial Management	Financial management includes the raising of revenue; the management and control of public expenditure; financial accounting and reporting; cash management; and, in some cases, asset management.
Gender	A concept that refers to the social differences between women and men that have been learned are changeable over time and have wide variations both within and between cultures. (European Commission, 1998)
Gender equality	The concept meaning that all human beings are free to develop their personal abilities and make choices without the limitations set by strict gender roles; that the different behaviour, aspirations and needs of women and men are considered, valued and favoured equally.

	(European Commission, 1998)
Gender equity	Fairness in women's and men's access to socio-economic resources […]. A condition in which women and men participate as equals and have equal access to socio-economic resources. (European Commission, 1998)
Gender gap	The gap in any area between women and men in terms of their levels of participation, access, rights, remuneration or benefits. (European Commission, 1998)
Gender mainstreaming	Mainstreaming a gender perspective is the process of assessing the implications for women and men of any planned action, including legislation, policies or programs, in any area and at all levels. It is a strategy for making women's as well as men's concerns and experiences an integral dimension of the design, implementation, monitoring and evaluation of the policies and programs in all political, economic and societal spheres so that women and men benefit equally, and inequality is not perpetuated. The ultimate goal is to achieve gender equality. (ECOSOC)
Gender (Responsive) Budgeting	An application of gender mainstreaming in the budgetary process. It means a gender-based assessment of budgets, incorporating a gender perspective at all levels of the budgetary process and restructuring revenues and expenditures in order to promote gender equality. (Council of Europe)
Gender-sensitive	Addressing and taking into account the gender dimension. (European Commission, 1998)
Line Item	In a line item system, expenditures for the coming year are listed according to objects of expenditure or "line items."
Outcome	Sometimes called the result and is used to describe what is intended to be achieved by the end of implementation on one or more activities. An outcome defines impact or effect we want to achieve in the society.
Operating Budget	Component of the core budget that is raised from government revenue and for which the government has sole charge of. Normally it is used for salaries and wages and goods and services but rarely acquisition of assets (capital) expenditure.
Objective	A concise statement of why a ministry exists, a program objective (often just referred to as an objective) describes one of several responsibilities of a ministry, and an operational objective describes a task associated with a particular sub-program (in order to achieve the objective of the program).
Outputs	Goods or services produced by an activity e.g. no of vaccinations.
Program	A grouping of Ministry functions according to a key objective, based on the main functions performed or services delivered by ministry. Normally there would be no more than 5 programs per Ministry.
Program-Based Budget	Program-based budgeting is linking government budget and other resources to the public policy objective. Program-based budgeting requires that program objectives stretch beyond a single fiscal year. Program-based budgeting requires effectiveness measures, which means the measurement of outputs and outcomes.
Performance Indicators	Performance indicators or performance measures are defined as "quantifiable, enduring measures of public sector **outputs, outcomes, and efficiency".**
Recurrent Activity	Package of ongoing and reoccurring operations that consumes inputs and produces a consumable good or service.
Strategic Plan	A plan that sets forth an organization's mission, goals, objectives, courses of action, and expected results for a specific time frame, usually five to ten years.
Sub program	For managerial efficiency, programs are often sub divided into smaller units of work. They must have a well-defined purpose, budget, and time line and be related directly to achieving the purpose of the program that is its host.

ANNEXURE F: BIBLIOGRAPHY

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