Chapter 5. ORGANIZATIONAL ISSUES IN BUDGET PREPARATION AND THE BUDGET APPROVAL PROCESS

A. Organizational Issues in Budget Preparation

1. Institutional Mechanisms for Policy Formulation

An overall strategic framework should underpin the formulation of sectoral policies provided that it is a genuine and concrete strategy, rather than a generic “mission statement”, or rhetorical vision. Within this framework, line ministries and agencies could prepare their own strategic plans, including: (i) their mandate, consistent with statutory requirements; (ii) a set of outcomes; (iii) the approaches to achieving these outcomes; (iv) a description of how activities and process will be used to achieve these objectives; and (v) a broad cost estimate. Performance plans can then be derived for these strategic plans (issues related to performance are discussed in chapter 15). Such strategic planning is not a static exercise or an occasional event, but a dynamic and inclusive process. If done well, strategic planning is continuous and provides the basis for everything the organization does each day. Regrettably, in many cases the exercise degenerates into bureaucratic formalism, where matrices, long-term vision and logical frameworks substitute for clear thinking rather than being used as instruments to make it explicit. A good practical rule in preparing (and evaluating) a strategic framework is: keep it simple.

There is no blueprint for the organizational arrangements for policy formulation. In all cases however, the relationship between government levels must be established by law. The common requirement is that they must ensure coherence and close coordination among the different actors. The “center of government”, i.e., depending on the country, the Prime Minister’s office, the President’s office, etc., should coordinate the policy formulation process. It must be able to set up policy priorities, coordinate interministerial committees, act as arbiter, launch and coordinate the preparation of strategic plans by sector ministries (or intersectoral committees for cross-cutting policy issues). The center of government therefore needs strategic planning capacity, which could consist of a small group of advisers relieved of day-to-day government coordination activities (but systematically in contact with the operational organs). In several developing countries, a dual policy decision-making process exists, since government is coordinated both by the President's office and the Prime Minister's office. In these cases, a clear demarcation of their respective roles is needed.

Line ministries should be responsible for policy making within their portfolios. This obvious principle bears underlining because it is so often violated—either by excessive intervention from the center on sector policy issues, or from the Ministry of Finance on sector budget issues, or from the Ministry of Planning when selecting sectoral projects included in the investment program or from donors lobbying in favor of pet projects, and/or from the line ministry itself seeking to evade responsibility by using any of the above as excuses.

The effectiveness of the line minister in coordinating sector policy can also be impeded by internal organizational arrangements within the line ministry itself. Thus, for example, in countries where substantial cuts have been made in the ministry's own current and investment budget, an autonomous fund that benefits from earmarked revenues or a state-owned enterprise in the sector can be much more powerful than the relevant minister.

As discussed in chapter 15, policy formulation can to an extent be separated from the delivery of the corresponding services. This can help avoid "capture" of the policy function by vested administrative interests. Moreover, in many developing and transition countries, decoupling policy advice from service delivery, without giving increased resources to the central departments responsible for policy advice, makes for fragmentation and inconsistency in the formulation of sector policies, since in effect these policies end up being formulated by the entities responsible for delivering the services. The typical outcome is that the Ministry of Finance deals directly with the service delivery entities when preparing the budget and the line ministry is barely involved or even informed—a different variant of "capture".

Australia has been successful in implementing super-ministries ("portfolio ministries"). These portfolio ministries were made responsible for defining priorities in their respective sectors under tight resource constraints. This organizational arrangement facilitates adjustments in the composition of expenditure programs.

Putting complementary programs under one portfolio highlights the need for trade-offs and gives room to finance new priorities through offsetting savings, while complying with the resource constraint. However, in other countries, a super-ministry could simply be the a grouping of “junior” ministries, adding an unnecessary layer of decision making to the machinery of government, tending to make policy formulation more complex.

Interministerial committees are needed to deal with cross-cutting policy issues (e.g., employment, environment), to coordinate policy areas that are covered by several ministries; or deal with special problems (e.g., regional issues). Setting up task forces can be a flexible way to tackle some special issues, provided that a specific sunset clause—is set and resolutely enforced. The administrative landscape in most countries contains several such entities, still surviving long after the need for their establishment has disappeared.

A cohesive civil service “culture” is important for policy coordination. Especially, problematic are systems where mobility is constrained not only by the usual obstacles, but also by the existence of several different professional “streams” with no possibility of moving between them. Normally, a system whereby officials move among ministries is better able to produce policy coordination than a system in which civil servants spend most of their careers in the same ministry. However, in cases where government is weak across the board and civil servants are incompetent or corrupt, greater mobility may simply serve to generalize incompetence or corruption, eliminate “pockets” of efficiency or honesty, and make reform that much harder.

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

Formal and clear communication and clearance channels are important to avoid implementation problems and misunderstanding, particularly in countries where personalized networks are important. The Cabinet must clearly be the locus where decisions are made; initiatives from ministries should be submitted to the center of government; initiatives that affect the public finances to the Ministry of Finance; and decisions must be systematically documented and formally communicated.[1]

Box 21
Key Prerequisites for Well-Functioning Cabinet Systems

An ADB study analyzed cabinet processes and procedures in six countries—Australia, Great Britain, Malaysia, Philippines, Singapore and Sri Lanka. It defined four broad criteria for good cabinet performance: efficiency, effectiveness, accountability and transparency.

The study showed that Cabinet systems seem to be more effective where:

- Extensive interministerial coordination takes place when proposals are prepared;
- Implementation of Cabinet decisions is tracked, through monitoring or other follow-up systems;
- Budgetary resources for implementing Cabinet policies are identified at an early stage of the policy process;
- The Cabinet as a whole takes and stands by decisions collectively;
- The Secretary to the Cabinet (or equivalent position) has the trust and confidence of the Prime Minister or President;
- The staff of the Cabinet/Secretariat is composed of highly respected, competent, experienced, and discrete professionals;
- Ministers and their Permanent Secretaries communicate openly and regularly;
- The number of Cabinet ministers is small, thus simplifying the task of coordination. Leaner Cabinets tend to allow for greater policy cohesion, as well as more efficient meetings;
- Cabinet business forecasting systems are in place;
- The cabinet agenda is limited to a few tough decision items; other routine or low-priority decisions are delegated to permanent secretaries and other line ministry officials;
- Real deliberation over most policy issues has taken place at the committee level before the issue is brought to the full Cabinet for ratification;
- Cabinet memoranda are well-written and concise, with clearly stated objectives and recommendations;
- Cabinet meeting minutes which briefly summarize decisions are conveyed clearly and quickly;
- Cabinet office or other staff brief the meeting's Chairperson (President or PM, or Minister, in the case of committee meetings) before each meeting;
- Cabinet office staff are motivated and regulated according to professional standards;
- Policy proposals are presented as multiple or preferred choices for decision by elected officials rather than as single options recommended without alternative by appointed officials;
- Extensive consultation on policy issues takes place among politicians and technocrats in both formal and informal settings;
- Mechanisms for public consultation are established;
- Written procedures guide the preparation of policy proposals and the implementation of policy decisions, and these procedures are open to public scrutiny; and
- The Cabinet office (or another part of the head of state's office) ensures that the government communicates clearly to the public the rationale for important and/or controversial policy decisions.

Source: Asian Development Bank, Case studies on central mechanisms for policy formulation, coordination and implementation in the Asia Pacific region (RETA 5685), June 1998.

2. Distribution of responsibilities for the macroeconomic framework

Generally, preparing macroeconomic projections should involve directly the agencies responsible for macroeconomic issues, normally the Ministry of Finance, the Central Bank, the Treasury Department, the Ministry of Planning (if any), the Statistics Bureau, and, as the occasion requires, sector ministries.

In some countries, a single agency is responsible for preparing of the macroeconomic framework (with the Central Bank normally responsible for its own monetary and balance-of-payments projections). In other countries, the responsibility for macroeconomic projections is fragmented, with the Ministry of Finance responsible for fiscal projections, the Ministry of Planning for projections for the real sector, the Statistics Bureau for short-term projections for the real sector and price forecasts. In these cases, the macroeconomic projections are simply the collected forecasts from different agencies. For administrative and bureaucratic reasons, whichever agency is responsible for putting together these forecasts is usually reluctant to amend them or to request revisions. The immediate result is lack of consistency of the projections and poor dialogue within the government on policy issues. The indirect result is greater influence by the external financial institutions involved in financing the requirements of the adjustment program. When responsibility is fragmented, therefore, it is essential for the country's policy autonomy to set up an inter-ministerial committee with the authority to scrutinize the different sets of projections, assess their realism and consistency, and require changes—with the assistance of a competent technical secretariat.

Another problematic situation arises when the agency responsible for the preparation of the macroeconomic framework is separated from the entity responsible for overall budget management. The argument in favor of such an arrangement is that it relieves the agency responsible for the macroeconomic framework from the pressures of day-to-day administration of the budget, thus allowing medium-term strategy to be better taken into account. In practice, however, this often disconnects the preparation of the macroeconomic framework from immediate issues, and transforms it into a pro-forma exercise, while the real issues are addressed elsewhere (typically during meetings between the IMF and the Central Bank and the Ministry of

Finance). Understandably, this encourages a mechanistic and lackadaisical attitude to macroeconomic projections, and the tendency to blame difficulties with budget implementation on the poor quality of someone else's forecasts.

Some developing countries have been successful in establishing good coordination mechanisms for the formulation of macroeconomic policy. In other countries, whatever the distribution of responsibilities for preparing the official macroeconomic framework, the Ministry of Finance must have the internal capacity to review the macroeconomic projections, assess the risks associated with the different macroeconomic and fiscal scenarios, and prepare its own macroeconomic scenario to serve as a basis for comparison and reality check.

3. Distribution of responsibilities in annual budget preparation

Different actors are involved in budget preparation: the center of government, the Ministry of Finance (which consists of both the Ministry of Finance and the Ministry of Planning in many developing countries) central departments of line ministries and, within line ministries, subordinate spending agencies. The quality of the budget depends largely on the mode of coordination that is established among these different actors.

The distribution of responsibilities in budget preparation should fit the distribution of responsibilities within the government. It should be established in the budget rules or guidelines, along clear lines in order to establish unquestioned rules for compliance and accountability in budget execution. The organization of the executive branch of government in most countries suggests a distribution of responsibilities along the following lines: [2]

- The center of government is not directly involved in the practical aspects of budget preparation, but plays a key role in the budgetary process, to ensure that it is carried out along the lines defined and arbitrate and smooth over any conflict that may appear among the actors, and assure participation by the relevant stakeholders.

- The Ministry of Finance has the leading role in budget preparation. It needs sufficient powers to ensure that both fiscal targets and policy objectives are taken into account at every step. It prepares fiscal targets and strategic prioritization among sectors; establishes guidelines for preparing sector programs and for preparing line ministries' requests; scrutinizes those requests; and drafts the budget. However, the Ministry of Finance should not become the only player in the process. The budget should not drive policies. The Ministry of Finance has to facilitate decisions on major policy choices and allocation of resources among sectors, not make those decisions. The Ministry of Finance has to review and screen requests, not prepare them, directly or indirectly, as is the case in "open-ended" budget preparation and incremental budgeting.

- Line ministries are responsible and accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and their sectoral budgets as well, but within the framework established by the government. Moreover, they (and not the center or the Ministry of Finance) should have the technical capacities and information needed for trade-offs among ongoing programs and appraise new programs. In turn, line ministries are responsible for formulating guidelines for their subordinate agencies and scrutinizing their draft budgets.

- Subordinate agencies should prepare their budgets within the guidelines provided by their immediate direct authority. Often, powerful agencies prefer to deal directly with the Ministry of Finance; this hampers the definition of consistent sector policies.

Most developed countries have organized the distribution of responsibilities in budget preparation along the above lines. In developing countries, by contrast, the role of the Ministry of Finance in budget preparation can be more extensive and can strongly interfere in the preparation and the composition of the sectoral budgets. In countries with poor governance, subordinate agencies may see the Ministry of Finance as a protector against the confiscation of resources by "advisers" to the minister or by the line ministry's central departments.[3] The informal network of technicians from the Ministry of Finance and the line ministries may try to use the complexity of a line-item budget to protect some sectors or items. However understandable this may be, this defensive approach generally gives poor results. Bad policies and weak governance cannot be corrected at micro-level by insulating temporarily a specific budget line item or subordinate agency.

4. The budget timetable

a. Budget circular

A budget circular generally introduces the budget preparation process to spending agencies. It is often a routine affair, giving deadlines for the presentation of line ministries' requests and some general recommendations.

For a sound budget preparation process, the budget circular should state clearly the fiscal targets and the policies proposed. Ideally, a budget circular should include the following elements:

- a statement of the macroeconomic and financial situation;
- the overall deficit target and expected resources;
- budget priorities;
- sectoral budget ceilings;
- allocations for continuing policies and programs (for this, a rolling expenditure programming process is required);
- an indication of the expenditure savings expected in ongoing programs;
- the format of the line ministries' budget requests (presentation of sector policy, performance indicators, etc.);
- specific recommendations on program/projects;
- guidelines for the preparation of the sector programs (i.e., minimum requirement in terms of economic analysis to support a proposed investment project);
- economic parameters such as the expected inflation rate and the exchange rate;

- the organization of the budget preparation process (calendar, forms to be completed, etc.).

b. *Budget preparation calendar*

For sufficient iteration between the top-down and the bottom-up approach, adequate time is needed, notably to allow line ministries to prepare their budgets and identify measures to comply with the ceilings.

In several developed countries, the budget circular for the next year is sent to spending agencies soon after the start of each fiscal year. Therefore, budget preparation starts nine to ten months before the budget is presented to the legislature. In the United States, taking into account the special role of Congress, the budget preparation takes about 18 months.

In some developing countries, budget preparation is sometimes starts early but the sectoral ceilings are announced much later, and across-the-board cuts or arbitrary choices have to be made at the last minute.

The optimal length of the budget calendar is difficult to establish, and depends on the country context. On the one hand, a short calendar (or a short time between the notification of ceilings and the deadline for presentation of the budget requests) does not allow line ministries and subordinate agencies to prepare their program properly, or leaves no time for the needed negotiations. On the other hand, a lengthy process could lead to a budget based on out-of-date estimates of economic and fiscal parameters, which in addition could not take into account the results of the execution of the previous year’s budget.

Unfortunately, countries with unstable and hard-to-forecast parameters (such as high-inflation countries) are precisely those countries that need more time to make the hard choices among their programs. Generally, a budget preparation period starting six months before the deadline for presentation of the budget to the legislature is appropriate in developing countries, but there is no hard rule, and no substitute for custom-tailoring the budget calendar to the specific country.

Box 22
Possible Timetable For Budget Preparation

Month	Phase
T-8	The macroeconomic framework is prepared.
T-7	Ceilings are determined by sector (for the annual budget *and, if prepared, MYE or PIP*); Cabinet approves strategy.
T-6	Budget circular is released.
T-4	Line ministries submit budget *(with forward cost estimates)*
T-3	Budget requests are reviewed and negotiated between MOF and individual line ministries *(and MYE or PIP). In dual budgeting systems, reviews are made jointly by MOF and Ministry of Planning.*
T-1	Budget is submitted to the legislature
T	Month when budget is approved by legislature

Partly drawn from Guidance for Fiscal Economists on Public Expenditure Management, FAD.

B. DISTRIBUTION OF RESPONSIBILITIES BETWEEN CENTRAL AND LOCAL GOVERNMENT

This volume is of necessity focused on central government expenditure. Nevertheless, certain key issues related to the fiscal relationship between national and subnational levels of government must be considered. As mentioned in chapter 2, each governmental entity (central government, states, municipalities, etc.) should have its own budget, enacted according to the provisions stipulated in the Constitution or by law. However, there are strong linkages between the budget of the central government and the budgets of subnational governments, which require particular attention when preparing the budget of the central government.

1. "Fiscal federalism": Key issues

The degree of devolution, assignment of expenditures and revenue arrangements should be tailored to the country context and depend on policy and political issues. However, central government budget managers need to be aware of the key principles that should govern these arrangements.

From an efficiency perspective, the Oates “decentralization theorem” states that: “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision.” Similarly, the European Union has adopted the “principle of subsidiarity”, for the assignment of responsibilities among its members. According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government.

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

The literature on fiscal federalism discusses these issues and gives hypothetical and real-life examples of expenditure assignment.[4] It also presents various contradictory points of view on the desirable degree of decentralization. The need for some increased fiscal decentralization is generally admitted. Many observers, however, stress the risk of loss in expenditure control, increased corruption, and inefficiencies in resource allocation that would result from hasty decentralization, even when theoretically justified.[5]

Box 23
Fiscal Management in Federal Systems

In the 1980s, Argentina and Brazil faced similar problems, with subnational deficits adding to excess public deficits and high inflation. In the 1990s, both countries continued with fiscal decentralization and with the struggle to bring about macroeconomic stability. Argentina had greater success, partly because it imposed a harder budget constraint on the public sector at the national level and it had stronger party control of the subnational governments and of the national legislators. For restraining local and state borrowing, getting the right incentives for subnational governments and particularly for its creditors, in Argentina, proved more effective than central government rules, in Brazil (Steven Webb and William Dillinger, 1998).

In the People's Republic of China, the implementation of the Budget Law in 1994 strengthened the basis for fiscal operations. Central approval of local budgets was abolished, and budgetary procedures were clarified, requiring the local and central budgets to be formulated in a consistent macroeconomic framework. Local governments were disallowed from financing any deficits through bond issues, bank borrowing, or grants from the central government. They were required to run balanced budgets or to use accumulated budgetary surpluses and extrabudgetary funds to finance deficits (IMF WP/97/129).

In any event, tax and revenue arrangements should be in conformity with expenditure assignments, and should take into account efficiency issues in tax administration. Such arrangements may include: (i) tax assignment, i.e., assignment of certain taxes to subnational governments; (ii) tax-sharing agreements; (iii) revenue sharing, whereby a share of a pool of tax revenue is given to the subnational levels of government; (iv) unconditional grants; (v) conditional "block grants", i.e., transfers from the central government subject to certain conditions or standards of service delivery; (vi) targeted grants for a specific purpose or project. Among the various possible alternatives, the Australian Grants Commission System has much to commend it. It has successfully equalized access to basic social services, while preserving the incentive of each state to provide the services more efficiently, and largely de-politicizing the contentious issue of federal-state revenue sharing.

2. Broad principles

Whatever the degree of devolution appropriate to the country, the framework that governs the relationships between the central and local governments and arrangements for budgeting should be clear and efficient. As noted at the outset, a legal framework should govern the relationship between the different levels of the government. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to assure smooth intergovernmental fiscal relations. Such mechanisms could operate through specialized bodies. In India, Australia, and Sri Lanka, for example, a Financial Commission deals with financial relationships between the central government and the other levels of the government; in Germany, a second chamber of Parliament with state representation contributes to intergovernmental policy coordination; and specialized sectoral coordination councils are common in many countries.

For *transparency and efficiency of management*:

- Each level of government should have clearly assigned responsibilities, regardless of what those responsibilities are assigned to government as a whole (see Box 24). Overlaps should generally be avoided, and long "concurrent lists" of shared responsibilities are particularly ambiguous.

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

- Subnational governments need to have a sound estimate of these resources before preparing their budgets. In some countries (e.g., Ukraine in 1996-97), local governments have to wait for the draft budget of the central government to be finalized before preparing their own budgets. Such lack of predictability hampers both efficiency and fiscal control at local levels. Without an indication of the level of resources to be transferred to them, subnational governments cannot adjust their expenditures to fiscal constraints. Accordingly, forecasts of revenues should be transmitted to local governments as soon as these are set, and estimates of grants to local governments need to be prepared early in the budget process of the central government.

- Incentives for increased efficiency are needed. Often the central government makes transfers to subnational governments when they make economies in public spending or improve their own tax collection. This evidently does not stimulate them to seek economies in service delivery or improve tax collection. Subnational governments must be allowed to benefit from savings they make, at least in a large part. (The same argument was made in chapter 2 with respect to commercial revenue of state agencies.)

- It could be desirable to agree on multi-year “contracts” between the central government and local governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include performance criteria, minimum standards for services rendered by local government, etc. They would define relationships in a transparent manner and would ensure predictability. As for any contract, of course, the utility of this arrangement would depend largely on how well it is monitored and respected.

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

Box 24
Defining China's Expenditure Assignments

To date, China has failed to work out a law that clearly defines expenditure responsibilities for different levels of government. Existing expenditure assignments are murky, and often, motivated by political expediency, shift between levels of government in ad hoc ways. The central government may shift its own expenditure responsibilities to provincial governments in times of difficulty and provincial governments may use their broader responsibilities to bargain for a larger share of revenue. Intergovernmental bargaining has weakened budgetary planning and control and contributed to the instability of China's fiscal system. Without first reaching decisions on expenditure assignment, the Chinese authorities have found it difficult to reform tax assignment rules and revenue-sharing mechanisms between the central and provincial governments.

Expenditure assignments between the provincial government and lower-level authorities, such as municipal and county, are even more vague. Local governments are often forced to take the responsibility that should be undertaken by higher-level government, accentuating the mismatch between local revenue and local expenditure responsibility. The lack of specificity and the unpredictability built into the current system of expenditure assignments have given rise to budgetary uncertainty for the central government and made fiscal planning an impossible task for provincial and local authorities, hence adversely affecting the supply of public goods and services in both quantity and quality.

Source: Reforming China's Public Finances, Ehtisham Ahmad, Gao Qiang & Vito Tanzi (editors), IMF, 1995.

For *expenditure control and strategic allocation of resources*:

- Fiscal targets should cover the *general* government.

- Revenue assignment should be fully consistent with expenditure assignment. Sufficient resources should be assigned to subnational governments to allow them to fulfill their duties. When new duties or responsibilities are transferred to subnational governments, compensatory measures should be provided on the revenue side. On the other hand, of course, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.

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

- Special mechanisms are needed to control local government borrowing (see Box 25 for arrangements in various countries).

- In case of local government budget overruns or accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, local authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited period of time until the situation is stabilized. (An exception should be explicitly provided for instances when the overrun or arrears are directly related to a downloading of central fiscal problems, as mentioned above.)

- A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal control and audit for subnational governments should be similar to those of the central government. This leads one back to the central question of local government administrative capacity, and hence the issue of the degree of decentralization.

- For policy analysis (as well as fiscal targets of general government), it is necessary to consolidate the expenditure of the different levels of government especially in decentralized systems and federal countries. It would be very difficult to know what is spent on key sectors based only on the account of the central government. For this purpose, local governments and central government should have a common functional and economic classification of expenditures.

Box 25
Arrangements for Controlling Subnational Government Borrowing

Country	**Local and municipal authorities/ Debt limits**
United States	All local governments must have a balanced budget. Most states have either a constitutional or a statutory requirement for a balanced budget.
Canada	No formal restrictions. Market mechanisms are in place.
United Kingdom	A balanced budget is required.
Sweden	A balanced budget is required. Local and municipal governments are responsible for their own debt.
Australia	The Australian Debt Council determines the total public debt and the distribution between the different government levels, but in practice market mechanisms operate.
New Zealand	Generally speaking, local governments must finance current expenditures with revenues for the same year.
Argentina	The provinces may contract debt both internally and externally. The Central Bank oversees the impact on the financial system, and the Ministry of the Economy oversees maximum external interest rates.
Brazil	The Federal Senate sets overall limits to the amount of debt that states, the Federal District, and the municipalities can contract, and establishes the rules and conditions for their external and internal credit operations.
Chile	Municipalities and state-owned enterprises are able to contract loans for special projects. But this requires a law that must also indicate how the loan is to be repaid.
Colombia	According to constitutional regulations, local government's debts may not exceed their ability for repayment. A law is in place that establishes graduated authorization procedures according to debt levels.
Mexico	The states may not, in any case, directly or indirectly contract obligations or loans with foreign governments, companies, or private parties; or loans that must be repaid in foreign currency. States and municipalities may contract loans only when they are for productive public investments.
Venezuela	Local and municipal entities may not contract loans without the authorization of federal authorities.

Source: Ter-Minassian, T. (1996) and Petrei, 1998.

C. APPROVAL OF THE BUDGET AND THE ROLE OF THE LEGISLATURE

1. Presentation of the budget to the legislature

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

In some countries, the budget is submitted to the legislature after the start of the fiscal year, owing to unavoidable delays in budget preparation, change in the composition of the Cabinet, or pending financial negotiations with IFIs. However, in other countries, delay is institutionalized. In Nepal, the budget is presented systematically to Parliament only days before the beginning of the fiscal year. Therefore, Parliament has to authorize the government to spend immediately one-sixth of the appropriations presented in a Budget Bill that it has not yet scrutinized. In China, the National People's Congress (NPC) does not meet to approve the budget until after the commencement of the fiscal year.[6] As a result, it is asked to approve appropriations for a budget that is already being implemented.

Under special circumstances delays may be justified. The organic law (or law on the budget system) should therefore include provisions authorizing the executive to commit expenditures before the budget is approved, under specified circumstances. These provisions should be based on the budget of the previous year, rather than on a budget that has not yet been scrutinized (e.g., an authorization to commit each month up to one-twelfth of the appropriations of the previous year, as in the continuing resolution used by the U.S. Congress when the budget is not approved before the start of the fiscal year in October). In all cases, care must be taken lest these special provisions are abused and become a systematic way to sidestep the normal budget process.

Members of the legislature have different preferences regarding the manner in which resources are allocated and are subject to a variety of pressures from their constituents. The sum of these various preferences and related claims can generate a systematic tendency to increase expenditure during budget debates (a phenomenon known as “log-rolling”). Accordingly, many countries have adopted procedural rules to regulate and limit legislative debates on the budget. These rules cover (i) the sequence of voting on the budget; and (ii) the legislature’s powers to amend the budget. In parliamentary systems with a clear majority of one party,[7] the budget prepared by the executive is routinely approved by the legislature; indeed, failure to approve the budget is equivalent to a vote of no confidence and normally results in the resignation of the government.[8]

To enforce ex-ante fiscal discipline, in several countries the budget is voted in two phases: the overall amount of the budget is voted first, and appropriations and allocation of resources among ministries are voted only in the second phase.[9] This procedure is aimed at protecting the aggregate expenditure limit and the overall fiscal target. The real impact of this procedure is unclear since legislators can anticipate the incidence of the overall amount of the budget on their pet programs before the first vote and decide the overall amount accordingly.[10] However, reviewing aggregate expenditures and revenues together has the advantage of allowing the legislature to discuss macroeconomic policy explicitly.

Legal powers of the legislature to amend the budget vary from one country to another. Three situations are possible:[11]

- *Unrestricted power* is the ability of the legislature to vary both expenditure and revenue in either direction, without the consent of the executive.[12] Presidential systems fit this model, although the “power of the purse” granted to the legislature is counterbalanced by a presidential veto (e.g., in the U.S. and the Philippines). This implies substantial legislative influence on the first two objectives of PEM (fiscal discipline and expenditure allocation) as well as some indirect influence on the third (practical management).

- *Restricted power* is the power to amend the budget within set limits, often relating to a maximum increase in expenditures or decrease in revenues. The extent of these restricted powers varies from country to country.[13] In the United Kingdom, France, and British Commonwealth countries, Parliaments are not allowed to propose amendments that increase expenditure and have very restricted powers. By contrast, Germany allows such amendments, but only with the consent of the executive. This implies very limited legislative influence on resource allocation and (indirectly) on operational management.

- *Balanced budget power* is the ability to raise or lower expenditures or revenues *as long as* there is a counterbalancing measure to maintain the budget balance. This intermediate arrangement concentrates legislative influence on resource allocation.

Limits on the power of the legislature to amend the budget are particularly needed where legislature debates lead systematically to increased expenditures, as recently the case in a number of FSU countries. The budget organic law should stipulate that legislative actions that increase expenditures can take effect only if these expenditures themselves are authorized in the budget or its supplementary acts. However, these limits should never hamper legislative review of the budget. In some countries, the budgetary role of the legislature may need to be increased rather than limited.

Strong and capable committees enable the legislature to develop its expertise and play a greater role in budget decision making. Generally, different committees deal with different facets of public expenditure management. For example, the Finance /Budget Committee reviews revenues and expenditures; a Public Accounts Committee assures legislative oversight; sectoral or standing committees deal with sectoral policy and may review sector budgets. Coordination between the activities of these committees should be effective. In countries where the role of the legislature in amending the budget is significant, amendments are prepared by committees rather than proposed on the floor by individual members.[14]

Time allocated for the legislative budget process and, within this process, for committee reviews is important for a sound scrutiny of the budget. Legislative budget deliberations last up to 75 days in India; in the German *Bundestag* they may last up to four months; in the U.S. Congress, sometimes even longer.

The legislature and its committees should have access to independent expertise for proper budget scrutiny. In India, for example, parliamentary committees are supported with secretarial functions and legislators have access to the Parliament library and associated research and reference services; the U.S. Congress benefits from competent staff of the appropriations committees as well as the services of the large and well-equipped Congressional Budget Office, and is assisted by the General Accounting Office with audits and information on program compliance and performance.

Committees should also have access to administrative information. In Germany, the budget committee interacts quasi-permanently with government departments through regular departmental briefings and expenditure reports. In India, the Public Accounts Committee receives reports and departmental accounts and revenue receipts from the Comptroller and the Auditor General (although this concerns the oversight function of the Parliament, rather than budget policies). Regular consultations between the administration and the legislative committees on budget policies and their implementation would strengthen the capacity of the legislature to review the budget.

D. KEY POINTS AND DIRECTION OF REFORMS

1. Key points

Responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined and delimited:

- The center of government (Prime Minister, President office, etc) coordinates policy formulation and arbitrates any conflict in budget preparation.

- The Ministry of Finance prepares guidelines, scrutinizes requests and ensures the coordination of the budget preparation process, and the overall consistency of the budget with policy and macroeconomic objectives.

- Line ministries and agencies are responsible for preparing their sector programs and budgets, within the policy framework decided by the government.

Assignment of expenditures to *subnational government* should be established on clear bases, and arrangements for revenues should follow expenditure assignments. When preparing its budget, the central government should avoid passing down the deficit to subnational governments. Any increased expenditure assignment must be balanced with compensatory measures on the revenue side.

To ensure both efficiency and fiscal discipline, incentives and sanctions are needed. Subnational governments should benefit from savings they make, but protective measures are required in case of mismanagement or budget overruns.

2. Directions of reform

The legislature is the appropriate locus of overall financial accountability, and adequate means should be given to the legislature to review policies and the budget:

- The budget should be presented to the legislature in a timely manner, to allow its proper scrutiny and the completion of budgetary debates before the beginning of the fiscal year.
- Legislative committees should have adequate resources.
- Aggregate revenue, expenditure, and fiscal targets should be reviewed together.

In order to contain pressures to increase expenditures, limits on the powers of the legislature to amend the budget may be needed (e.g., any amendment that increases expenditures or decreases revenues should be accompanied by a counterbalancing measure to maintain the initial deficit target). The legal framework should stipulate that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or its supplementary acts.

---

[1] In France, for example, their function is exercised systematically by the General Secretariat of the Government.
[2] If one except the U.S. system, where legislature has an extensive role in the budget preparation process.
[3] In February 1997, in a seminar on budget management in Yaounde Cameroon, the strongest opposition to increased responsibilities of line ministries in budget formulation and execution came from the heads of remote spending units, who feared losing the support of the Ministry of Finance in getting at least minimal budgetary resources.
[4] See Shah, 1994, and Ter-Minassian, 1997.
[5] See Prudhomme, 1995.
[6] Ahmad, et al, 1995.
[7] E.g., in Italy last year.
[8] E.g., in Italy in late 1998.
[9] For example, in the U.S. since the Budget Act of 1974, and in France, etc.
[10] See Alesina and Perotti, 1996.
[11] Drawn up from Krafchik and Wehner, 1998.
[12] In the U.S., congress restricts its own power through the annual Budget Resolution setting spending targets for congressional committees. In 1990, for example, Congress prescribed that new benefits in entitlements could be provided only to the extent that other entitlements would be cut or new revenues raised. However these are self-imposed restrictions, which can be lifted at any time by legislative action, and are thus different from the restriction imposed from outside the legislature.
[13] See von Hagen and Harden, 1996; ——, 1992; Milesi-Ferretti, 1996.
[14] In the US, the annual Budget Resolution (which, as a resolution, does not require the President's approval) contains an overall spending target or cap.