

Chapter 4. THE BUDGET PREPARATION PROCESS

A. OBJECTIVES OF BUDGET PREPARATION

During budget preparation, trade-offs and prioritization among programs must be made to ensure that the budget fits government policies and priorities. Next, the most cost-effective variants must be selected. Finally, means of increasing operational efficiency in government must be sought. None of these can be accomplished unless financial constraints are built into the process from the very start. Accordingly, the budget formulation process has four major dimensions:¹

- Setting up the fiscal targets and the level of expenditures compatible with these targets. This is the objective of preparing the macro-economic framework.
- Formulating expenditure policies.
- Allocating resources in conformity with both policies and fiscal targets. This is the main objective of the core processes of budget preparation.
- Addressing operational efficiency and performance issues.

This chapter focuses on the core processes of budget preparation, and on mechanisms for aggregate expenditure control and strategic allocation of resources. Efficiency and performance issues are discussed in chapter 15. Operational efficiency questions directly related to the arrangements for budget preparation are discussed in Section D below.

B. THE IMPORTANCE OF A MEDIUM-TERM PERSPECTIVE FOR BUDGETING

The need to address all three objectives of public expenditure management—fiscal discipline, strategic resource allocation, and operational efficiency—is emphasized in chapter 1. This calls for a link between policy and budgeting and for a perspective beyond the immediate future.

Of course, the future is inherently uncertain, and the more so the longer the period considered. The general trade-off is between policy relevance and certainty. At one extreme, government “budgeting” for just the following week would suffer the least uncertainty but also be almost irrelevant as an instrument of policy. At the other extreme, budgeting for a period of too many years would provide a broad context but carry much greater uncertainty as well.² In practice, “multiyear” means “medium-term,” i.e., a perspective covering three to five years including the budget year.

Clearly, the feasibility in practice of a multiyear perspective is greater when revenues are predictable and the mechanisms for controlling expenditure well-developed. (The U.K., for example, has recently moved beyond a multiyear perspective to an outright three-year budget for most budgetary accounts.) These conditions do not exist in many developing countries.³ The dilemma is that a multiyear perspective is especially important in those countries where a clear sense of policy direction is a must for sustainable development, and public managers are often in sore need of some predictability and flexibility.⁴

The dilemma that a multiyear perspective is especially needed where it is least feasible cannot be resolved easily, but must not be ignored. On the one hand, to try and extend the time horizon of the budget process under conditions of severe revenue uncertainty and weak expenditure control would merely lead to frequent changes in ceilings and appropriations, quickly degenerate into a formalistic exercise, and discredit the approach itself, thus compromising later attempts at improvement. On the other hand, to remain wedded to narrow short-term “management” of public expenditure would preclude a move to improved linkage between policies and

expenditures. In practice, therefore, efforts should constantly be exerted to improve revenue forecasting (through such means as relieving administrative or political pressures for overoptimistic forecasts), and strengthen the linkages between policy formulation and expenditure, as well as the expenditure control mechanisms themselves. As and when these efforts yield progress, the time horizon for budget preparation can and should be lengthened. Because revenue-forecasting improvements and the strengthening of policy-expenditure links and expenditure control mechanisms are important in any event, efforts to achieve these can yield the double benefit of improving the short-term budget process at the same time as they permit expanding the budget time horizon to take account of developmental priorities.

Therefore, although in almost all countries government budgets are prepared on an annual cycle, to be formulated well they must take into account events outside the annual cycle, in particular the macroeconomic realities, the expected revenues, the longer-term costs of programs, and government policies. Wildavsky (1986, p. 317) sums up the arguments against isolated annual budgeting as follows:

short-sightedness, because only the next year's expenditures are reviewed;
overspending, because huge disbursements in future years are hidden;
conservatism, because incremental changes do not open up large future vistas;
and parochialism, because programs tend to be viewed in isolation rather than in comparison to their future costs in relation to expected revenue.

Specifically, the annual budget must reflect three paramount multiannual considerations:

- The future recurrent costs of capital expenditures;
- The funding needs of entitlement programs (for example debt service and transfer payments) where expenditure levels may change, even though basic policy remains the same;
- Contingencies that may result in future spending requirements (for example government loan guarantees (see chapter 2)).

A medium-term outlook is necessary because the time span of an annual budget is too short for the purpose of adjusting expenditure priorities and uncertainties become too great over the longer term. At the time the budget is formulated, most of the expenditures of the budget year have already been committed. For example, the salaries of permanent civil servants, the pensions to be paid to retirees, debt service costs, and the like, are not variable in the short term. Other costs can be adjusted, but often only marginally. The margin of maneuver is typically no more than 5 percent of total expenditure. This means that any real adjustment of expenditure priorities, if it is to be successful, has to take place over a time span of several years. For instance, the government may wish to switch from blanket provision of welfare services to targeted provision designed for those most in need. The expenditure implications of such a policy change stretch over several years, and the policy therefore can hardly be implemented through a blinkered focus on the annual budget.

Medium-term spending projections are also necessary to demonstrate to the administration and the public the desired direction of change. In the absence of a medium-term program, rapid spending adjustments to reflect changing circumstances will tend to be across-the-board and ad hoc, focused on inputs and activities that can be cut in the short term. (Often, these are important public investment expenditures, and one of the typical outcomes of annual budgeting under constrained circumstances is to define public investment in effect as a mere residual.) If the expenditure adjustments are not policy-based, they will not be sustained. By illuminating the expenditure implications of current policy decisions on future years' budgets, medium-term spending projections enable governments to evaluate cost-effectiveness and to determine whether they are attempting more than they can afford.⁵

Finally, in purely annual budgeting, the link between sectoral policies and budget allocations is often weak. Sector politicians announce policies, but the budget often fails to provide the necessary resources.

However, two pitfalls should be avoided. First, a multiyear expenditure approach can

itself be an occasion to develop an evasion strategy, by pushing expenditure off to the out-years. Second, it could lead to claims for increased expenditures from line ministries, since new programs are easily transformed into “entitlements” as soon as they are included in the projections. To avoid these two pitfalls, many developed countries have limited the scope of their multiyear expenditures estimates to the cost of existing programs, without making room for new programs.”⁶

Three variants of medium-term year expenditure programming can be considered:

- A mere “technical” projection of the forward costs of ongoing programs (including, of course, the recurrent costs of investments).
- A “stringent” planning approach, consisting of: (i) programming savings in nonpriority sectors over the planned period, to leave room for higher-priority programs; but (ii) including in the multiyear program ongoing programs and *only* those new programs that are included in the annual budget currently under preparation or for which financing is *certain*. Such plans include only a few new projects beyond their first planned year (e.g., the Public Investment Program prepared in Sri Lanka until 1998).
- The “classic” planning approach, which identifies explicitly new programs and their cost over the entire period. This includes “development plans” covering all expenditures, or many public investment programs currently prepared in several developing countries, as well as expenditure plans prepared in developed countries in the 1970s. Where the institutional mechanisms for sound policy decision making and for budgeting are not in place, this approach can lead to overloaded expenditure programs.

The feasibility of implementing these different approaches and their linkages with the annual budget depends on the capacity and institutional context of the specific country. However, the annual budget should always be placed into some kind of multiyear perspective, even where formal multiyear expenditure programming is not feasible. For this purpose two activities are a must: (i) systematic estimates of the

forward costs of ongoing programs, when reviewing the annual budget requests from line ministries; (ii) *aggregate* expenditure estimates consistent with the medium-term macroeconomic framework (see section C). It is often objected that estimating forward costs is difficult, especially for recurrent costs of new public investment projects. This is true, but irrelevant, for without such estimates budgeting is reduced to a short sighted and parochial exercise.

[Please see attached Figure 4.xls]

C. CONDITIONS FOR SOUND BUDGET PREPARATION

In addition to a multiyear perspective, sound annual budget preparation calls for making early decisions and for avoiding a number of questionable practices.

1. The need for early decisions

By definition, preparing the budget entails hard choices. These can be made, at a cost, or avoided, at a far greater cost. It is important that the necessary trade-offs be made explicitly when formulating the budget. This will permit a smooth implementation of priority programs, and avoid disrupting program management during budget execution. Political considerations, the avoidance mechanisms mentioned below, and lack of needed information (notably on continuing commitments), often lead to postponing these hard choices until budget execution. The postponement makes the choices harder, not easier, and the consequence is a less efficient budget process.

When revenues are overestimated and the impact of continuing commitments is underestimated, sharp cuts must be made in expenditure when executing the budget. Overestimation of revenue can come from technical factors (such as a bad appraisal of the impact of a change in tax policy or of increased tax expenditures), but often also from the desire of ministries to include or maintain in the budget an excessive number of programs, while downplaying difficulties in financing them. Similarly, while underestimation of expenditures can come from unrealistic assessments of the cost of unfunded liabilities (e.g. benefits granted outside the budget) or the impact of

permanent obligations, it can also be a deliberate tactic to launch new programs, with the intention of requesting increased appropriations during budget execution. It is important not to assume that “technical” improvements can by themselves resolve institutional problems of this nature.

An overoptimistic budget leads to accumulation of payment arrears and muddles rules for compliance. Clear signals on the amount of expenditure compatible with financial constraints should be given to spending agencies at the start of the budget preparation process. As will be stressed repeatedly in this volume, it is possible to execute badly a realistic budget, but impossible to execute well an unrealistic budget. There are no satisfactory mechanisms to correct the effects of an unrealistic budget during budget execution. Thus, across-the-board appropriation “sequestering” leads to inefficiently dispersing scarce resources among an excessive number of activities. Selective cash rationing politicizes budget execution, and often substitutes supplier priorities for program priorities. Selective appropriation sequestering combined with a mechanism to regulate commitments partly avoids these problems, but still creates difficulties, since spending agencies lack predictability and time to adjust their programs and their commitments.

An initially higher, but more realistic, fiscal deficit target is far preferable to an optimistic target based on overestimated revenues, or underestimated existing expenditure commitments, which will lead to payment delays and arrears. The monetary impact is similar, but arrears create their own inefficiencies and destroy government credibility as well. (This is a strong argument in favor of measuring the fiscal deficit on a “commitment basis”, see chapter 6.)

To alleviate problems generated by overoptimistic budgets, it is often suggested that a “core program” within the budget be isolated and higher priority given to this program during budget implementation. In times of high uncertainty of available resources (e.g., very high inflation), this approach could possibly be considered as a second-best response to the situation. However, it has little to recommend it as general practice, and is vastly inferior to the obvious alternative of a realistic budget to begin with. When applied to current expenditures, the “core program” typically includes

personnel expenditures, while the “noncore program” includes a percentage of goods and services. Cuts in the “noncore” program during budget execution would tend to increase inefficiency, and reduce further the meager operations and maintenance budget in most developing countries. The “core/noncore” approach is ineffective also when applied to investment expenditures, since it is difficult to halt a project that is already launched, even when it is “non-core.” Indeed, depending on strong political support, noncore projects may in practice chase out core projects. (See chapter 12 for a discussion of public investment programming.)

2. The need for a hard constraint

Giving a hard constraint to line ministries from the beginning of budget preparation favors a shift from a “needs” mentality to an availability mentality. As discussed in detail later in this chapter, annual budget preparation must be framed within a sound macroeconomic framework, and should be organized along the following lines:

- A top-down approach, consisting of: (i) defining aggregate resources available for public spending; (ii) establishing sectoral spending limits that fits government priorities; and (iii) making these spending limits known to line ministries;
- A bottom-up approach, consisting of formulating and costing sectoral spending programs within the sectoral spending limits; and
- Iteration and reconciliation mechanisms, to produce a constant overall expenditure program.

Although the process must be tailored to each country, it is generally desirable to start with the top-down approach. Implementation of this approach is always necessary for good budgeting, regardless of the time period covered. The technical articulation of this approach in the context of medium-term expenditure programming is discussed in chapter 13, for the annual budget.

3. Avoiding questionable budgeting practices

Certain budgetary practices are widespread but inconsistent with sound budgeting. The main ones are: “incremental budgeting,” “open-ended” processes, “excessive bargaining,” and “dual budgeting.”

a. Incremental budgeting

Life itself is incremental. And so, in part, is the budget process, since it has to take into account the current context, continuing policies, and ongoing programs. Except when a major “shock” is required, most structural measures can be implemented only progressively. Carrying out every year a “zero-based” budgeting exercise covering all programs would be an expensive illusion. At the other extreme, however, “incremental budgeting,” understood as a mechanical set of changes in a detailed line-item budget, leads to very poor results. The dialogue between the Ministry of Finance and line ministries is confined to reviewing the different items and to bargaining cuts or increases, item by item. Discussions focus solely on inputs, without any reference to results, between a Ministry of Finance typically uninformed about sectoral realities and a sector ministry in a negotiating mode. Worse, the negotiation is seen as a zero-sum game, and usually not approached by either party in good faith. Moreover, incremental budgeting of this sort is not even a good tool for expenditure control, although this was the initial aim of this approach. Line-item incremental budgeting focuses generally on goods and services expenditures, whereas the “budget busters” are normally entitlements, subsidies, hiring or wage policy or, in many developing countries, expenditure financed with counterpart funds from foreign aid.

Even the most mechanical and inefficient forms of incremental budgeting, however, are not quite as bad as capricious large swings in budget allocations in response to purely political power shifts.

b. “Open-ended” processes

An open-ended budget preparation process starts from requests made by spending

agencies without clear indications of financial constraints. Since these requests express only “needs,” in the aggregate they invariably exceed the available resources. Spending agencies have no incentive to propose savings, since they have no guarantee that any such savings will give them additional financial room to undertake new activities. New programs are included pell-mell in sectoral budget requests as bargaining chips. Lacking information on the relative merits of proposed expenditures, the Ministry of Finance is led to making arbitrary cuts across the board among sector budget proposals, usually at the last minute when finalizing the budget. At best, a few days before the deadline for presenting the draft budget to the Cabinet, the Ministry of Finance gives firm directives to line ministries, which then redraft their requests hastily, themselves making cuts across the board in the programs of their subordinate agencies. Of course, these cuts are also arbitrary, since the ministries have not had enough time to reconsider their previous budget requests. Further bargaining then takes place during the review of the budget at the cabinet level, or even during budget execution.

“Open ended” processes are sometimes justified as a “decentralized” approach to budgeting. Actually, they are the very opposite. Since the total demand by the line ministries is inevitably in excess of available resources, the Ministry of Finance in fact has the last word in deciding where increments should be allocated and whether reallocations should be made. The less constrained the process, the greater is the excess of aggregate ministries’ request over available resources, the stronger the role of the central Ministry of Finance in deciding the composition of sectoral programs, and the more illusory the “ownership” of the budget by line ministries.

c. *Excessive bargaining and conflict avoidance*

There is always an element of bargaining in any budget preparation, as choices must be made among conflicting interests. An “apolitical” budget process is an oxymoron. However, when bargaining *drives* the process, the only predictable result is inefficiency of resource allocation. Choices are based more on the political power of the different actors than on facts, integrity, or results. Instead of transparent budget appropriations, false compromises are reached, such as increased tax expenditures,

creation of earmarked funds, loans, or increased contingent liabilities. A budget preparation process dominated by bargaining can also favor the emergence of escape mechanisms and a shift of key programs outside the budget.⁷

A variety of undesirable compromises are used to avoid internal bureaucratic conflicts—spreading scarce funds among an excessive number of programs in an effort to satisfy everybody, deliberately overestimating revenues, underestimating continuing commitments, postponing hard choices until budget execution, inflating expenditures in the second year of a multiyear expenditure program, etc. *These conflict-avoidance mechanisms are frequent in countries with weak cohesion within the government. Consequently, improved processes of policy formulation can have benefits for budget preparation as well, through the greater cohesion generated in the government.*⁸

Conflict avoidance may characterize not only the relationships between the Ministry of Finance and line ministries, but also those between line ministries and their subordinate agencies. Indeed, poor cohesion *within* line ministries is often used by the Ministry of Finance as a justification for its leading role in determining the *composition* of sectoral programs. Perversely, therefore, the all-around bad habits generated by “open-ended” budget preparation processes may reduce the incentive of the Ministry of Finance itself to push for real improvements in the system.

d. *“Dual budgeting”*

There is frequent confusion between the separate presentation of current and investment budgets, and the issue of the *process* by which those two budgets are prepared. The term “dual budgeting” is often used to refer to either the first or the second issue. However, as discussed earlier, a separate presentation is needed. “Dual budgeting” refers therefore only to a *dual process* of budget preparation, whereby the responsibility for preparing the investment or development budget is assigned to an entity different from the entity that prepares the current budget.

"Dual budgeting" was aimed initially at establishing appropriate mechanisms for giving higher priority to development activity. Alternatively, it was seen as the application of a "golden rule" which would require balancing the recurrent budget and borrowing only for investment. In many developing countries, the organizational arrangements that existed before the advent of the PIP approach in the 1980s (see chapter 12) typically included a separation of budget responsibilities between the key core ministries. The Ministry of Finance was responsible for preparing the recurrent budget; the Ministry of Planning was responsible for the annual development budget and for medium-term planning. The two entities carried out their responsibilities separately on the basis of different criteria, different staff, different bureaucratic dynamics, and, usually, different ideologies. In some cases, at the end of the budget preparation cycle, the Ministry of Finance would simply collate the two budgets into a single document that made up the "budget." Clearly, such a practice impedes the integrated review of current and investment expenditures that is necessary in any good budget process. (For example, the Ministry of Education will program separately its school construction program and its running costs and try to get the maximum resources for both, while not considering variants that would consist of building fewer schools and buying more books.)

In many cases, coordination between the preparation of the recurrent budget and the development budget is poor not only between core ministries but within the line ministries as well. While the Ministry of Finance deals with the financial department of line ministries, the Ministry of Planning deals with their investment department. This duality may even be reproduced at subnational levels of government. Adequate coordination is particularly difficult because the spending units responsible for implementing the recurrent budget are administrative divisions, while the development budget is implemented through projects, which may or may not report systematically to their relevant administrative division. (In a few countries, while current expenditures are paid from the Treasury, development expenditures are paid through a separate Development Fund.) The introduction of rolling PIPs was motivated partly by a desire to correct these problems.⁹

Thus, the crux of the "dual budgeting" issue is the lack of integration of different

expenditures contributing to the same policy objectives. This real issue has been clouded, however, by a superficial attribution of deep-seated problems to the “technical” practice of dual-budgeting. For example, dual budgeting is sometimes held responsible for an expansionary bias in government expenditure. Certainly, as emphasized earlier, the initial dual budgeting paradigm was related to a growth model (Harrod-Domar et al) based on a mechanistic relation between the level of investment and GDP growth. *This paradigm itself* has unquestionably been a cause of public finance overruns and the debt crises inherited in Africa or Latin America from bad-quality investment “programs” of the 1970s and early 1980s. The implicit disregard for issues of implementation capacity, or efficiency of investment, or mismanagement, corruption and theft, is in hindsight difficult to understand. However, imputing to dual budgeting all problems of bad management or weak governance and corruption is equally simplistic and misleading. Given the same structural, capacity, and political conditions of those years (including the Cold War), the same outcome of wasteful, and often corrupt, expansion of government spending would have resulted in developing countries—dual budgeting or not. If only the massive economic mismanagement in so many countries in the 1970s and early 1980s could be explained by a single and comforting “technical” problem of budgetary procedure! In point of fact, the fiscal overruns of the 1970s and early 1980s had little to do with the visible dual budgeting. They originated instead from a *third* invisible budget: “black boxes,” uncontrolled external borrowing, military expenditures, casual guarantees to public enterprises, etc.¹⁰

Public investment budgeting is submitted to strong pressures because of particular or regional interest (the so-called pork barrel projects) and because it gives more opportunities for corruption than current expenditures.¹¹ Thus, in countries with poor governance, there are vested interests in keeping separate the process of preparing the investment budget, and a tendency to increase public investment spending. However, under the same circumstances, to concentrate power and bribe opportunities in the hands of a powerful “unified-budget” baron would hardly improve expenditure management or reduce corruption. On the contrary, it is precisely in these countries that focusing first on improving the integrity of the separate investment programming process may be the only way to assure that some resources

are allocated to economically sound projects and to improve over time the budget process as a whole.¹²

By contrast, in countries without major governance weaknesses, dual budgeting often results in practice in insulating current expenditures (and especially salaries) from structural adjustment. Given the macroeconomic and fiscal forecasts and objectives, the resources allocated to public investment have typically been a residual, estimated by deducting recurrent expenditure needs from the expected amount of revenues (given the overall deficit target). The residual character of the domestic funding of development expenditures may even be aggravated during the process of budget execution, when urgent current spending preempts investment spending which can be postponed more easily. In such a situation, dual budgeting yields the opposite problem: unmet domestic investment needs and insufficient counterpart funds for good projects financed on favorable external terms. Insufficient aggregate provision of counterpart funds (which is itself a symptom of a bad investment budgeting process) is a major source of waste of resources.

Recall that the real issue is lack of integration between investment and current expenditure programming, and not the separate processes in themselves. This is important, because to misspecify the issue would lead (and often has) to considering the problem solved by a simple merger of two ministries—even while coordination remains just as weak. A former minister becomes a deputy minister, organizational “boxes” are reshuffled, a few people are promoted and others demoted. But dual budgeting remains alive and well within the bosom of the umbrella ministry. When coordination between two initially separate processes is close and iteration effective, the two budgets end up consistent with each other and with government policies, and “dual budgeting” is no great problem. Thus, when the current and investment budget processes are separate, whether or not they should be unified depends on the institutional characteristics of the country. In countries where the agency responsible for the investment budget is weak, and the Ministry of Finance is not deeply involved in ex-ante line-item control and day-to-day management, transferring responsibilities for the investment budget to the Ministry of Finance would tend to improve budget preparation as a whole. (Whether this option is preferable to the alternative of

strengthening the agency responsible for the investment budget can be decided only on a country-specific basis.) In other countries, one should first study carefully the existing processes and administrative capacities. For example, when the budgetary system is strongly oriented toward ex-ante controls, the capacity of the Ministry of Finance to prepare and manage a development budget may be inadequate. A unified budget process would in this case risk dismantling the existing network of civil servants who prepare the investment budget, without adequate replacement. Also, as noted, coordination problems may be as severe between separate departments of a single ministry as between separate ministries. Indeed, the lack of coordination *within line ministries* between the formulation of the current budget and the formulation of the capital budget is in many ways the more important dual budgeting issue. *Without integration or coordination of current and capital expenditure at line the ministries' level, integration or coordination at the core ministry level is a misleading illusion.*

On balance, however, the general presumption should be in favor of a single entity responsible for both the investment and the annual budget (although that entity must possess the different skills and data required for the two tasks):

Where coherence is at a premium, where any consistent policy may be better than several that cancel each other out, where layers of bureaucracy already frustrate each other, and where a single budget hardly works, choosing two budgets and two sets of officials over one seems strange. The keynote in poor countries should be simplicity. Designs for decisions should be as simple as anyone knows how to make them. The more complicated they are, the less likely they are to work. On this basis, there seems little reason to have several organizations dealing with the same expenditure policies. One good organization would represent an enormous advance. Moreover, choosing the finance ministry puts the burden of reform where it should be—in the budgetary sphere.¹³

D. THE MACROECONOMIC AND POLICY CONTEXT

1. Macroeconomic framework and fiscal targets

a. Importance of a macroeconomic framework

The starting points for expenditure programming are: (i) a realistic assessment of resources likely to be available to the government; and (ii) the establishment of fiscal objectives. (There follows, of course, significant iteration between the two, until the desired relationship between resources and objectives is reached.)

As noted earlier, the capacity to translate policy priorities into the budget, and then to ensure conformity of actual expenditures with the budget, depends in large part on the soundness of macroeconomic projections and revenue forecasts. Overestimating revenues leads to poor budget formulation and therefore poor budget execution. (As mentioned earlier, this may sometimes be a deliberate ploy to evade the responsibility for weak budget management and discipline.)

The preparation of a macroeconomic framework is therefore an essential element in the budget preparation process. Macroeconomic *projections* are not simple *forecasts* of trends of macroeconomic variables. Projections are based on a definition of targets and instruments, in areas such as monetary policy, fiscal policy, exchange rate and trade policy, external debt policy, regulation and promotion of private-sector activities, and reform of public enterprises. For example, the policy objective of reducing inflation normally corresponds to targets such as the level of the deficit, and the specific instruments can include tax measures and credit policy measures, among others.¹⁴ Projections should cover the current year and a forward period of two to four years.

b. Fiscal targets and indicators

The establishment of explicit fiscal targets gives a framework for budget formulation, allows the government to state clearly its fiscal policy and the legislative and the public to monitor the implementation of government policy, and, ultimately, makes government politically as well as financially accountable. Fiscal targets and indicators should cover three areas: current fiscal position (e.g., fiscal deficit), fiscal sustainability (e.g., debt-, tax-, or expenditure-to-GDP ratios), and vulnerability (e.g., analysis of the composition of the foreign debt).

The summary indicator of *fiscal position* used most commonly is the overall *budget deficit on a cash basis*, defined as the difference between actual expenditure payments and collected revenues (on a cash basis) plus grants (cash or in kind).¹⁵ The cash deficit is by definition equal to the government borrowing requirements (from domestic or foreign sources) and is thus integrally linked to the money supply and inflation targets and prospects. The deficit is therefore a major policy target to ensure that the budget will be financed in a noninflationary way and without crowding out private investment, while keeping the growth of public debt under control. The cash deficit must always be included in the set of fiscal targets.

The cash deficit does not take into account payment arrears and floating debt. In countries that face arrears problems the *deficit on a cash basis plus net increase of arrears* is also an important indicator, and is very similar (but not necessarily identical) to the *deficit on a commitment basis*, i.e., the difference between annual expenditure commitments and cash revenues and grants.¹⁶ The IMF Code of Fiscal Transparency requires at least a memorandum reporting arrears, when the country does not use accrual or modified accrual accounting (which would systematically generate reports on overdue accounts; see chapter 10).

As discussed in chapter 6, the precise definition of commitment varies from one country to another¹⁷. Commitments include orders not yet delivered, may concern multiyear contracts, or, in some countries, be only the administrative reservation of appropriations. Therefore, when using the deficit on a commitment basis as fiscal indicator, it is necessary to specify what transactions are included in the expenditures

on a commitment basis. This indicator would be meaningless if it includes multiyear commitments and commitments that are merely reservations of appropriations. Moreover, to estimate arrears more accurately, orders not yet delivered should be separated from actual expenditures (“accrued expenditures,” or “expenditures at the verification stage”). As discussed in chapters 6 and 10, this requires an adequate accounting system for tracking the uses of appropriations.

The *primary deficit* (on either a cash or a commitment basis) is the difference between noninterest expenditures and revenues and grants. As a target for budget policy, it does not depend on the vagaries of interest rates and exchange rates, and is therefore a better measure of the government’s fiscal adjustment effort.

In high-inflation countries, to take into account the impact of inflation on the stock of debt, a frequent indicator is the *operational deficit*, which is equal to the deficit on a cash basis less the inflationary portion of interest payment.¹⁸

The *current deficit* is the difference between current revenue and current expenditure. It is by definition, the “government saving,” and thus, in theory, the contribution of government to investible resources and economic growth. However, since the current spending of a government may be as important for growth as capital spending, the macroeconomic meaning of this indicator should be interpreted with care.

Depending on the circumstances, it may also be necessary to isolate once and for all the fiscal results from other operations, as, for instance, the sale of public assets, or a special recovery of tax arrears.¹⁹

[Please see attached Table 2.xls]

It is essential to underline that the broad objective of fiscal policy is not a specific level of deficit, per se, but a fiscal position that is *sustainable* in light of policy goals and likely resource availability. Indicators of *fiscal sustainability* include the ratio of debt to GDP, tax to GDP, net unfunded social security liabilities. The calculation of the deficit on an accrual basis and the assessment of the net worth of the government allows a

better assessment of liabilities and therefore their impact on sustainability (see chapter 10). However, huge movements in net worth can be caused by valuation changes in assets such as land, that the government has no immediate intention of liquidating. Hence, "net worth measures could be dangerous if used as indicators for near-term fiscal policy."²⁰

An assessment of *fiscal vulnerability* is also needed, especially in countries that benefit from short-term capital inflows. Especially relevant to Asian countries affected by the financial crisis that began in 1997; such an assessment could be based on the analysis of the maturity of government debt, the volume of usable foreign exchange reserves, etc. There is no question that the standard deficit measures may indicate a healthy fiscal situation which is in reality fragile. However, as shown by recent developments, guidelines for assessing fiscal vulnerabilities are doubtful and unclear. This question is related to the perennial and difficult issue of "early warning systems" to predict the probability of an impending fiscal or financial crisis. It may well be that such early warnings are feasible and appropriate. Among the thorny difficulties, however, there is the risk of a self-fulfilling prophecy, where the early warning itself could cause financial markets to become concerned and hence spark a crisis. Thus, on the "balance" of the debate, against any real crisis that an early warning system has predicted accurately, one should place other crises, that might not have happened were it not for the warning itself.

c. *Preparation of a macroeconomic framework*

A macroeconomic framework typically includes projections of the balance of payments, the real sector (i.e., production), the fiscal accounts, and the monetary sector. It is a tool for checking the consistency of assumptions or projections concerning economic growth, the fiscal deficit, the balance of payments, the exchange rate, inflation, credit growth and the share of the private and public sectors on external borrowing policies, etc.²¹

Preparing a macroeconomic framework is always an iterative exercise. A set of “initial” objectives must be defined to establish a preliminary baseline scenario, but the final framework requires a progressive reconciliation and convergence of all objectives and targets. Considering only one target (e.g., the fiscal deficit) in this iterative exercise risks defining other important targets as de facto residuals.

“General government” (see chapter 2) should be considered when preparing the fiscal projections and defining the fiscal targets, but the fiscal targets should also be broken down between central and local government. In some decentralized systems, by law a fiscal target cannot be directly imposed on subnational and local government. In those cases, it is necessary to assess the feasibility of achieving it by means of the different instruments under the control of the central government (such as grants, control of borrowing). However, the constraints on running fiscal deficits are typically much tighter on subnational entities than they are on central government. The main reason is the central government’s capacity to regulate money supply. Therefore, in some federal systems (e.g., the U.S.) many states have their own constitutionally mandated requirement of an annual balanced budget.

Fiscal projections should cover the consolidated account of the general government and quasi-fiscal operations by the banking system. Future expenditures related to contingent liabilities as a result of government guarantees should be assessed (see chapter 2). In a majority of developing countries, it is desirable to prepare “consolidated accounts of the public sector,” to identify financing requirements for the public sector as a whole. Very often, however, only the central government is included, giving a misleading fiscal picture and the temptation to “download” the fiscal deficit onto local government entities. This practice is conducive neither to sound fiscal policy nor to the subsidiarity structure appropriate to the specific country. Unfortunately, governments and international financial institutions have paid insufficient attention to this problem.

The degree of sophistication of fiscal projections depends on the technical capacities within the country and the availability of data and appropriate tools. Sophisticated

models can be useful. Nevertheless, since the major objective is to set a general frame for formulating macroeconomic objectives and checking their consistency, the preparation of a macroeconomic framework does not necessarily require sophisticated modeling techniques. On the contrary, these techniques may give a sense of misplaced concreteness and a “forecast illusion” which may hamper the practical value of the framework.

Using simple “quasi-accounting” models would already represent significant progress in many countries.²² Such models include mainly accounting relations (e.g., GDP plus net imports equals consumption plus investment) and only a limited number of behavioral relations defined by simple ratios (e.g., consumption, income), without resorting to econometric techniques. The models are also easier to use in discussions on fiscal policy, whereas the outputs of a sophisticated econometric model depend on the approach adopted by the modeler, and the process is necessarily more opaque. In any case, forecasting revenues should be based on detailed analyses and forecasts by individual tax rather than on the aggregate outputs of a macroeconomic model.

The problems revealed by the projections (e.g., lack of consistency between economic growth targets and monetary policy) must be discussed among the agencies involved in macroeconomic management. The preliminary baseline scenario gives the macroeconomic information needed for preparing sectoral and detailed projections, but these projections usually lead in turn to revising the baseline scenario. Such iterations should continue until overall consistency is achieved for the macroeconomic framework as a whole. The iteration process is not only necessary for sound macroeconomic and expenditure programming, but is also an invaluable capacity-building tool, to improve the awareness and understanding of involved agencies—and therefore their cooperation in formulating a realistic budget and implementing it correctly.

[Please see attached Figure 5.xls]

The preparation of a macroeconomic framework should be a permanent activity. The

framework needs to be prepared at the start of each budget cycle to give adequate guidelines to the line ministries. As noted, it must then be updated throughout the further stages of budget preparation, also to take into account intervening changes in the economic environment. During budget execution, too, macroeconomic projections require frequent updating to assess the impact of exogenous changes or of possible slippage in budget execution.

In addition to the baseline framework, it is important to formulate variants under different assumptions, e.g., changes in oil prices. The risks related to unexpected changes in macroeconomic parameters must be assessed and policy responses identified in advance, albeit in very general terms, of course.

The importance of good data cannot be underestimated. Without reliable information, the macroeconomic framework is literally not worth the paper it is written on. This includes the collection of economic data and the monitoring of developments in economic conditions (both of which are generally undertaken by statistics bureaus) as well as the monitoring and consideration of changes in laws and regulations that affect revenue, expenditure, financing and other financial operations of the government.

2. Aggregate expenditure estimates

Typically, a macroeconomic framework is at a very aggregate level on the expenditure side, and shows total government wages, other goods and services, interest, total transfers, and capital expenditures (by source of financing). Assumptions and underlying policy objectives therefore concern the broad economic categories of expenditures, rather than the allocation of resources among sectors. Moreover, transfers or entitlements are not reviewed in sufficient detail and assumptions on future developments are not compared with continuing commitments. Thus, when elaborating a fiscal framework on the basis of the overall macroeconomic framework, estimates of the impact of the assumptions and the aggregate fiscal targets on the composition of expenditure, by sector or economic category, are required to assess whether the fiscal targets are realistic and sustainable, and to

determine the conditions to meeting these targets.

Therefore, the preparation of aggregate expenditure estimates could help in assessing the sustainability of expenditure policy, and thus improve the budget preparation process (notably when defining expenditure ceilings for the various sectors). These estimates could cover: (i) the forward costs of large investment projects; (ii) projections for the more important entitlements; and (iii) aggregate projections of other expenditures, by function and broad economic category. These estimates are less demanding in terms of capacity and institutional process than the formal Medium-Term Expenditure Framework (MTEF) described in chapter 13, but could be a step toward the implementation of a comprehensive MTEF. Indeed, this step is mandatory if some *sectoral* multiyear expenditure programming exercise is carried out (covering only investment or a few sectors), to prevent inconsistency between the sectoral program and the macroeconomic framework, or the crowding out of expenditure in noncovered sectors or categories.

Focusing only on technical issues while neglecting the fundamental question of the division of administrative responsibility inevitably produces a weak or inoperative macroeconomic framework. Some major considerations in this respect are discussed in chapter 5.

3. Consolidating the fiscal commitments

a. Making the macroeconomic projections public

While the iterative process leading to a realistic and consistent macroeconomic framework must remain confidential in many of its key aspects, when the framework is completed it must be made public. The legislature and the population at large have a right to know clearly the government policy objective and targets, not only to increase transparency and accountability, but also to reach a consensus within civil society. While such a consensus may take additional time, and require difficult debates, it will also be an invaluable foundation for the robust and effective implementation of the

policy and financial program. A good example is provided by the government of Hong Kong, China, which annexes its medium-term forecast to the annual budget speech (box 16 and annex VII).

Box 16
Medium-Range Forecasts: The Example of Hong Kong, China

The Medium Range Forecast (MRF) is a projection of expenditure and revenue for the forecast period based on forecasting assumptions and budgetary criteria. To derive the MRF, a number of computer-based models that reflect a wide range of assumptions about the factors determining each of the components of government's revenue and expenditure were used. As summary is shown here, a fuller description is in Annex VII.

Assumptions relating to developing expenditure and revenue forecast over the medium-term period are the following:

- estimated cash flow of capital projects
- forecast completion dates of capital projects and their related recurrent consequences in terms of staffing and running costs
- estimated cash flow arising from new commitments resulting from policy initiatives
- the expected pattern of demand for individual services
- the trend in yield from individual revenue sources
- new revenue measures in 1998-1999

In addition to these assumptions, there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy:

- Maintain adequate reserves in the long-term
- Expenditure growth should not exceed the assumed trend growth in GDP
- Contain capital expenditure growth within overall expenditure guidelines
- Revenue projections reflect new measures introduced in this year's budget

To summarize, the MRF of Hong Kong is shown below: (in \$Hk billion)

	Forecast years			
	<u>1998-1999</u>	<u>1999-2000</u>	<u>2000-2001</u>	<u>2001-2002</u>
Revenue	192,680	211,390	242,900	271,330
Expenditure	182,480	200,740	227,830	258,570
Surplus	10,200	10,650	15,070	12,760
Total public expenditure	288,890	315,830	354,060	393,980
Gross domestic product	1,497,880	1,690,740	1,908,420	2,154,130
Growth in GDP (nominal)	12.9	12.9	12.9	12.9
(real)	5.0	5.0	5.0	5.0
Public expenditure as a percentage of GDP	19.3	18.7	18.6	18.3

Source: Medium Range Forecast of Hong Kong, The Internet, August 8, 1998.

In some countries, government projections are submitted to a panel of independent and respected experts to ensure their reliability, while preserving the confidentiality required on a few sensitive issues. In other countries, the projections are validated by the Auditor General (e.g., the United Kingdom and the Canadian province of Nova Scotia²³). The independence of the Auditor General adds credibility to the projections. However, any other form of participation of audit offices in the budget formulation process would be questionable. In any event, manipulation and alteration of forecasts would soon reduce the government's credibility and hence its influence.

b. Binding fiscal targets?

Several countries have laws and rules that restrict the fiscal policy of government ("fiscal rules").²⁴ For example, an earlier golden rule stipulated that public borrowing must not exceed investment (thus mandating a current budget balance or surplus). In some cases, the overall budget must be balanced by law (as in subnational government in federal countries). In the European Union, the Maastricht Treaty stipulates specific fiscal convergence criteria, concerning both the ratio of the fiscal deficit to GDP and the debt/GDP ratio. (The former has been by far the more important criterion.) One frequent criticism of such rules is that they favor creative accounting and encourage nontransparent fiscal practices. When they are effectively enforced, nondiscretionary rules can also prevent governments from adjusting their budgets to the economic cycle.²⁵ Aside from the special case of European integration, one may generally consider that, in countries with fragile coalition governments, fragmented decision making, and legislative committees acting as a focus for periodic bargaining, setting up legally binding targets may be appropriate. In other countries, however, binding targets could in effect predetermine the budget before its preparation even begins.²⁶

In contrast with an approach based on rigid targets, other countries (e.g., New Zealand) do not mandate specific fiscal targets, but refer to criteria such as prudent levels and reasonable degrees. It is left to the government to specify the targets in a Budget Policy Statement, which presents total revenues and expenses and

projections for the next three years. This statement is published at least three months before the budget is presented to Parliament, and is reviewed by a Parliament committee but not formally voted by Parliament.²⁷

Box 17
The New Zealand Fiscal Responsibility Act

Enacted in 1994, the New Zealand Fiscal Responsibility Act offers a comprehensive legal framework for formulation and conducting fiscal policy in general, and for incorporating a long-term orientation in the budget process in particular. While many OECD countries have similar practices in place, the Fiscal Responsibility Act is an example of these practices being enacted into law.

The primary objective of the Fiscal Responsibility Act was to entrench sound fiscal policies and make it difficult for future governments to deviate from them. There are two provisions of the Act: (i) a regime for setting fiscal objectives that focuses attention on the long term; and (ii) an extensive system of fiscal reporting with unique mechanisms to ensure its credibility and integrity. The extensive reporting required by the act serves two purposes. First, it serves to monitor the consistency of the government's fiscal actions with its stated fiscal objectives. Second, it brings general transparency to government finances by mandating the disclosure of all relevant fiscal information in a timely manner.

The act requires two specialized reports: the Fiscal Strategy Report and the Pre-Election Economic and Fiscal Update. The Fiscal Strategy Report, which is presented to Parliament along with the budget, assesses the consistency of the policy framework contained in the budget with the short-term fiscal intentions and long-term fiscal objectives outlined in the Budget Policy Statement. The Pre-Election Economic and Fiscal Update contains the three-year forecasts of all key economic and fiscal variables. Both reports contain two statements of responsibility, one by the Minister of Finance and one by the Secretary to the Treasury (a civil servant). These statements of responsibility aim to clarify the roles of politicians and civil servants in producing reports and give a greater role to civil servants in producing them, thereby increasing the overall credibility of the reports.

Source: "Budgeting for the future," OECD working paper, 1997.

More important than specifying ex-ante targets and general criteria is to ensure that institutional arrangements and processes favor coherence among resource constraints, fiscal objectives, and expenditure programs. This broader issue involves the mechanisms for policy formulation, the budget preparation process, the role of the Ministry of Finance in budgeting, and the development of appropriate instruments for reviewing expenditures within a longer period than the annual budget.

Box 18

A Good Macroeconomic Coordination Practice: The “Gang of Four” in Thailand

The Thai system of budgeting is highly centralized. It embodies a longstanding set of arrangements, rules, and procedures that together help exert discipline on aggregate fiscal management. It grants very little autonomy to line agencies over their budgets, and imposes weak accountability on them for their performance.

The hallmark of the Thai budgeting system is aggregate fiscal discipline. A “gang of four” interacts to control the level of spending and thus the deficit: the National Economic and Social Development Board (NESDB), the Ministry of Finance (MOF), the Bank of Thailand (BOT), and the Bureau of the Budget (BOB) in the Prime Minister’s Office. The gang of four is responsible for formulating the macroeconomic framework that serves as the basis for the aggregate expenditure ceiling. It also determines for the most part the ministerial ceilings. Prioritization is largely a function of the gang of four. It ensures that the budgetary requests of line agencies are consistent with the objectives of the five-year development plan. The gang of four’s control over aggregate allocations to agencies and to expenditure categories implies that it exerts considerable leverage over priority setting.

In Parliament, the Budget Scrutiny Committee chaired by the Minister of Finance evaluates the government’s proposal. Cabinet members can propose amendments to the government’s proposal but seldom make significant changes in allocations to line agencies because of limited technical capability to evaluate such proposals. Politicians can alter the allocation of line agencies. After a series of deliberations and negotiations, the committee submits the budget bill to Parliament. The Parliament almost always accepts the bill.

Source: Campos and Pradhan, “Budgetary institutions and expenditure outcomes, 1996.

4. Policy formulation

a. *Importance of policy formulation*

The budget preparation process is a powerful tool for coherence. The budget is both an instrument of economic and financial management and an implicit policy statement, as it sets relative levels of spending for different programs and activities. However, policy decision making is complex and involves different actors in and outside the government. It is a technocratic illusion to embed all policy formulation within the budget process (as to some extent was the ambition of the PPBS; see chapter 3). However, a coherent articulation should be sought between the policy agenda (which should take into account economic and fiscal realities) and the budget (which should accurately reflect the government's policy priorities).

The budget process should both take into account policies already formulated and be the main instrument for making these policies explicit and “operational.” However, policies must be defined outside the pressure of the budget process. Making policy *through* the budget would lead to a focus only on short-term issues and thus to bad policy, since the policy debate would be invariably dominated by immediate financial considerations. (This is frequently the unfortunate outcome in developing countries with weak capacity faced with financial difficulties.) In earlier times, medium-term development plans were intended as the instrument for setting up government strategy. However, these plans were rigid, invariant, and usually out of sync with financial realities. Paradoxically, therefore, they indirectly led in practice to the same dominance of short-term financial considerations. Organizational arrangements are discussed in chapter 5.

b. *The policy-budget link*

A bridge between the policy making process and the budget process is essential to make policy a breathing reality rather than a statement of wishes. For this purpose at least two clear rules must be established.²⁸

The resource implications of a policy change should be identified, even if very roughly, before a policy decision is taken. Any entity proposing new policies must quantify their effects on public expenditure, including the impact both on its own spending and on the spending of other government departments.

The Ministry of Finance should be consulted in good time about all proposals involving expenditure before they go into ministerial committee or to the center of the government and certainly before any public announcements are made.

Within the budget formulation process, close cooperation between the Ministry of Finance and the center of government is required, at both the political and the technical level. The role of the center is to ensure that the budget is prepared along the lines defined; to arbitrate or smooth over conflicts between the Ministry of Finance and line ministries; and to assure that the relevant stakeholders are appropriately involved in the budget process. (This is a major challenge, which can only be mentioned here but requires care and commitment on a sustained basis.) An interministerial committee is needed to tackle crosscutting issues and review especially sensitive issues. And, most importantly, each entity involved in the budget process must perform its own role in a responsible fashion, and be given the means and capacity to do so.

c. Reaching out: The importance of listening

Consultations can strengthen legislative scrutiny of government strategy and the budget. Legislative hearings through committees and subcommittees, particularly outside the pressure environment of the annual budget, can provide an effective mechanism for consulting widely on the appropriateness of policies (issues related to the role of the legislature are discussed in chapter 5) .

The government should try to get feedback on its policies and budget execution from the civil society. Consultative boards, grouping representatives from various sectors in society, could discuss government expenditure policy. On crucial policy issues

government can set up ad hoc groups. Preparing evaluation studies and disseminating them, conducting surveys, etc. provides information to stakeholders and the civil society and helps the government receive reliable feedback. User surveys and/or meetings with stakeholders and customers when preparing agencies' strategic plans or preparing programs can enhance their effectiveness. Finally, and most concretely, in countries with weak budget execution and monitoring mechanisms, only mechanisms for eliciting feedback from far-flung citizens can be effective in revealing such malpractices as "ghost schools," shoddy infrastructure, incomplete projects, thefts, and waste. Such mechanisms are often resented by the executive branch, but should be seen by governments (and external donors) as remarkably cost-effective monitoring devices, and encouraged and supported as such.

However, although these consultations must have an influence on budget decisions, a direct and mechanical linkage to the budget should be avoided. As noted, the budget preparation process needs to be organized along strict rules so that the budget can be prepared in a timely manner while avoiding excessive pressure from particular interests and lobbies. Participation, like accountability, is a relative, not absolute, concept.

E. RESOURCE ALLOCATION AND OPERATIONAL EFFICIENCY

As stressed earlier, budget preparation is an iterative process between the Ministry of Finance and spending ministries. Therefore, it is a combination of a top-down approach, with the Ministry of Finance giving guidelines or communicating instructions to spending ministries, and a bottom-up approach, with spending ministries presenting requests for budget allocation to the Ministry of Finance. Either approach followed in isolation would have adverse effects: ["A budget created from the bottom-up may lead to excessive spending and instability, if not carefully organized and subject to pre-established limits. By contrast, a highly centralized exercise introduces rigidities and loses the vision of those who are close to the service recipients (Petrei, 1998, p. 399). The articulation of the top-down and bottom-up approach is crucial since it determines how priorities and fiscal targets will be taken into account over the budget preparation

process.

1. Top-down approach

As previewed earlier, the starting points for budget preparation are a clear definition of fiscal targets and a strategic framework consisting of a comprehensive set of objectives and priorities. Thereafter, strong coordination of the budget preparation is required to achieve the necessary iteration and to avoid major departures from the initial framework.

Giving a hard constraint to line ministries from the start of budget preparation favors a shift from a “needs” mentality to an “availability” mentality. Moreover, to translate strategic choices and policies into programs, line ministries require clear indications on available resources. Finally, a hard constraint increases the de facto authority and autonomy of the line ministries, weakening the claim of the Ministry of Finance to a role in determining the *internal* composition of the line ministries’ budget. (The same is true of each line ministry vis-à-vis its subordinate agencies.)

This calls for notifying spending agencies of the initial budget ceilings and preferably in absolute terms, or at least through the provision of accurate and complete parameters. These ceilings may be defined either at the very beginning of the dialogue between the Ministry of Finance and the line ministries, or after a first iteration when line ministries communicate their preliminary requests. In practice, two variants are found in countries that have good financial discipline. In some, line ministries are notified of the sectoral ceilings at the very start of the budget preparation process. Other countries, where budget preparation may last more than ten months, establish ceilings in two steps. In the first step, some flexibility is left to line ministries to translate guidelines in terms of budget envelopes. Then, after a brief review and discussion of the preliminary requests, the Ministry of Finance notifies the line ministries of the binding ceilings. In countries with strong government cohesion and stable and well-organized arrangements for budget preparation, the two variants are equally workable, since financial constraints are more or less taken into account by line ministries when preparing their preliminary request. Moreover, when budget

preparation lasts nearly one year²⁹ it would be very difficult to set definite ceilings at the start of the process.

However, in countries where fiscal discipline and government cohesion are not firmly established (as in most developing countries), adopting a gradual approach to building financial constraints into the budget preparation process could mean a simple comeback to a fully open-ended process. Therefore, the notification of definite budgetary envelopes at the beginning of the budgetary process is highly desirable in these countries.

Coordination and consistency of budget policy with overall economic and social policy is a central concern of Cabinet, although the Ministry of Finance must play the key role in analysis and formulating recommendations.

Generally, the Ministry of Finance should be responsible for setting the sectoral ceilings, but it should of course coordinate with the center of government, which must also review the ceilings in detail and approve them. In some countries, the sectoral ceilings are discussed within interministerial committees; in other countries, proposed ceilings and guidelines for budget preparation are submitted to the Cabinet. Where responsibilities for budgeting are split between a Ministry of Finance and a Ministry of Planning, the preparation of sectoral expenditure ceilings must be undertaken by a joint committee including at least the two ministries. The institution responsible for overall financial management should coordinate the setting of the sectoral ceilings to ensure that they fit the aggregate expenditure consistent with the macroeconomic framework.

2. Bottom-up approach

Line ministries are responsible for preparing their requests within the spending limits provided. Depending on the severity of the fiscal constraint and the organization of the budget preparation process, additional requests from line ministries could be allowed for new programs. However, the principal request should be consistent with the notified ceilings or guidelines, and costs of programs included in the additional

requests should be clear and fully adequate for proper implementation, without any underestimation. Naturally, no request for new programs should be entertained without a clear demonstration of its purpose and, where appropriate an estimate of the demand for the services to be provided.

Line ministries' budget requests should clearly distinguish: (i) the amount necessary to continue current activities and programs; and (ii) proposals and costing for new programs.

Before deciding to launch any new expenditure program it is necessary to assess its forward budget impact. This is particularly important for development projects and entitlement programs, which may generate recurrent costs or increased expenditures in the future. This assessment is required whether or not a formal exercise of multiyear expenditure programming is carried out. For this purpose, requests must show systematically the forward annual costs of multiyear or entitlement programs, and the Ministry of Finance should take into account the forward fiscal impact of these programs when scrutinizing the budgetary requests from line ministries. Estimates of future costs related to multiyear commitments could be annexed to the overall budget document. These estimates would facilitate the preparation of the initial ceilings for the next budget.

In addition to their budget requests, the submission from the line ministries should include: (i) a brief policy statement spelling out the sector policies and expected outcomes; (ii) where applicable, realistic and relevant performance indicators, including results from the previous period and expected performance for the future; (iii) a statement of how the objectives will be achieved; (iv) proposals for achieving savings and boosting efficiency; and (v) clear measures for implementing the proposals effectively.

Line ministries must coordinate the preparation of the budget of their subordinate agencies and give them appropriate directives. The submission of budget requests from subordinate agencies, in general, should meet the same criteria as noted above for line ministries' requests.

3. Negotiation

Once it receives the requests of line ministries, the Ministry of Finance reviews their conformity with overall government policy, and compliance with the spending limits; reviews performance issues; and takes into account changes in the macroeconomic environment since the start of budget preparation. Almost always, these reviews lead the Ministry of Finance to suggest modifications in the line ministries' budget requests. Negotiation follows.

Formal negotiation between the Ministry of Finance and line ministries can take the form of a budgetary conference. Professional staff from the Ministry of Finance and line ministries should also hold informal meetings to avoid misunderstandings and minimize conflicts. Major differences of opinion will normally be referred to the center of government, depending largely on the relative balance of administrative and political power between the Ministry of Finance and the specific line ministry concerned.

4. Preparing expenditure ceilings

In preparing the sectoral expenditure ceilings, the following elements must be taken into account:

Macroeconomic objectives and fiscal targets;

The results of the review of ongoing programs for the sector;

The impact of ongoing expenditure programs on the next budget, and their degree of rigidity (notably expenditures related to continuing commitments, such as entitlements);

The strategy of the government concerning possible shifts in the intersectoral distribution of expenditure, and the amount of resources that could be allocated to

new policies as well as service demand projections where appropriate.

Preparing these initial ceilings is largely an incremental/decremental exercise. Budgets are never prepared from scratch. Debt servicing, multiyear commitments for investment; pensions and other entitlements; rigidities in civil service regulations; and the simple reality that government cannot stop at once all funding for its schools, health centers or the army, etc, limit possible annual shifts to perhaps 5-10 percent of total expenditures. In theory, this percentage could be higher in developing countries than in developed countries (where the share of entitlements is higher). But in practice, because of earlier overcommitments the room to maneuver is often even lower in developing countries. If one excludes emergency or crisis situations, when preparing the budget the government should focus on new policies, savings on questionable programs, and means of increasing the efficiency of other ongoing programs. It is clear, once again, that any significant policy shift requires a perspective longer than one year and some advance programming, in whatever form that is appropriate and feasible in the specific country.

a. *A subceiling for capital expenditure?*

As discussed earlier, a separate budget preparation process for capital and current expenditure (“dual budgeting”) presents problems, but a separate *presentation* is desirable. Aside from that question, however, should separate ceilings for capital and current expenditures be set at the start of the budget preparation process? The answer depends on the sector concerned.

Obviously, if only a global ceiling is set, line ministries would be able to make trade-offs between their current spending and their capital spending, and if separate ceilings are set, the distribution between current and capital spending is fixed for each sector. In certain sectors, such as primary education, it is generally preferable to leave the choice between current and capital spending partly to line ministries, since both current and capital expenditures are “developmental,” and line ministries presumably know better than the Ministry of Finance what would be the most efficient allocation of resources within their sector. However, in some cases, the sector budget depends

largely on the decision of whether or not to launch a large investment project. For example, the budget of a Ministry of Higher Education would largely depend on the decision whether to construct a new university. Because such large investment projects are a government policy issue, not only a sectoral policy issue, separate ceilings would be appropriate in these cases. Depending on circumstances and fiscal policy issues, separate subceilings may also be needed for other expenditure items, such as personnel expenditures and subsidies.

b. Efficiency “dividends”

In recent years, Australia demanded from each spending unit, efficiency dividends, i.e., required savings in their ongoing activities (around 1.5 percent annually). On the surface, this practice may look like the typical (and undesirable) across-the-board cuts made by the Ministry of Finance when finalizing the budget. However, there are two major differences: (i) efficiency dividends are notified early in the process and within a coherent multiyear expenditure framework; and (ii) the allocation of savings among activities and expenditure items is entirely the responsibility of the spending agencies, which alleviates the arbitrary nature of the approach. Savings “measures are much more likely to be implemented within the ministry when the line ministry itself is arguing for them rather than when they are set by the central agencies”, with the knowledge and skills of the program agency being devoted to criticism and obfuscation”.³⁰ This approach appears to have achieved effective results in Australia during 1985-90. Sweden has adopted a similar approach.³¹

In developed countries, the potential for fiscal savings and efficiency improvements exists. Before considering introducing efficiency dividends in developing countries, the country context must be carefully reviewed. Efficiency dividends differ from across-the-board cuts only if there are adequate technical capacities in line ministries and a willingness to make their own hard choices. In those developing countries where the current budget is too inadequate to allow departments even to function normally (and the capital budget is determined largely by donor funding), the real question is not how to generate a gradual increase in efficiency, but how to restructure the public expenditure program by eliminating questionable programs altogether (and/or

increase tax collection). Certainly, in the long run, the savings from the efficiency dividends system may be expected to weaken.³² And, where evaluation capacity is weak, the risk that the efficiency dividends are achieved by diminishing service or program quality are very real. However, this practice may be an invaluable aid to introducing greater performance orientation in a complacent administrative system, and triggering more structural improvements.

5. The role of multiyear estimates in budget preparation

We discussed in section B the importance of a multiyear perspective for budgeting. When fully integrated into the budget process, rolling multiyear expenditure programming can contribute to enhancing the preparation of the annual budget. As discussed in detail in chapter 13, in some developed countries (e.g., Australia and Denmark) multiyear expenditure estimates prepared the previous year are the starting point of the budget preparation process. Budgetary negotiations focus on new policies, with costs of ongoing programs being updated only on technical grounds based on the multiyear estimates prepared the previous year. In the U.S., the Office of Management and Budget and the Congressional Budget Office prepare five-year projections.

A possible interrelation between the preparation of multiyear estimates and the preparation of the annual budget is presented in figure 6. When launching budget preparation, the multiyear estimates prepared the previous year are used to assess constraints related to existing policy commitments. This assessment and estimate of the financial constraints give the basis for estimating initial expenditure ceilings that frame the preparation of sector requests. Then, the multiyear expenditure program is updated and rolled over when preparing the budget. This process ensures both that the initial ceilings are prepared appropriately and that forward costs of programs are taken into account when preparing the budget.

Box 19

The Role of Multiyear Estimates In Budget Preparation

Australia

To start budget preparation, the Department of Finance updates the forward estimates and establishes the baseline projections which include only the estimated costs of approved programs in the absence of policy change. Using these projections, the Cabinet indicates the broad aggregate targets for the budget and forward years. Decisions made by the Government in the budget process are added to the baseline forward estimates which do not include any allowance for policy changes. Budget decisions focus therefore on incremental adjustments -up or down- to the baseline.

Denmark

When the budget is passed by Parliament in December, an appendix to the Appropriation Bill contains projected expenditures for each of the next three years at the same price and pay basis as the appropriations. Work on the next budget starts shortly thereafter. The budget department in the Finance Ministry adjusts the multiyear projections to the pay and price assumptions to be used in preparing the next budget. In February, the Minister of Finance proposes to the Cabinet a set of net spending ceilings, one for each minister, and the new aggregate target. These ceilings set the framework for the drafting of budget proposals in the various ministries. In effect, the ceilings define an expenditure block for each ministry, allowing a significant flexibility in arranging its budget proposals. After this, negotiations on the budget focus on accommodating new expenditures and cutback options for ministries that have difficulty keeping within the agreed limits.

Drawn from OECD, "Budgeting for results," 1995.

Unfortunately, a "rolling" program is often only cosmetic, with attention really focused only on the first budget year. For a rolling approach to be genuine and thus effective, the key steps would be the following:

The Ministry of Finance updates the costs of the MYEs prepared the previous year, taking into account expected developments in economic parameters, budget execution and expenditure reviews. In carrying out this task, it consults line ministries to get appropriate information, including on changes in the level of demand for services but the exercise is made on a technical basis, without interference or "bargaining" for additional resources.

Taking into account policies, implementation problems, and possible improvements in efficiency, the Ministry of Finance identifies savings that can be made on ongoing programs over the planned period.

Once the global envelope for the annual tranches of the MYE is established, the annual envelopes for new programs are set.

The sectoral distribution of the annual envelopes for new programs is determined, in conformity with government priorities, by the Ministry of Finance or by an

interministerial committee, consulting the line ministries when necessary.

For the planned period, annual sectoral ceilings are communicated to line ministries, distinguishing ongoing programs and envelopes for new programs. Depending on the context, they may also include other elements, such as estimated costs of large investment projects, funds to be reserved to finance the counterpart costs of ongoing projects, and caps on personnel expenditures.

Line ministries are free to identify realistic new savings on ongoing programs, and to recapture the corresponding resources within the limits of the ceilings.

Requests from line ministries are reviewed by the Ministry of Finance, then in joint committee.

This approach requires the preparation of sound cost estimates and discipline in budgeting and decision making. chapter 13 describes in detail the Medium-Term Expenditure Framework. Even if a full-fledged MTEF covering all expenditures is not feasible, linkages between a rolling investment program (or even only estimates of future costs of ongoing programs), and annual budgeting can be established. A multiyear approach permits reconciling the reality that budgeting is inevitably incremental in large part, with the need for significant shifts in the composition of public expenditure.

Box 20
Use of Computer Technology in Budget Preparation: Singapore

The Budget Operations Support System (BO\$\$), the computerized system of Singapore, incorporates the budget allocation rules that compute the percentage share of the GDP to be allocated to the various ministries on the basis of the centrally controlled financing formula. The allocation should be shared between recurrent and development expenditures. The BO\$\$ produces the draft budget spreadsheets for each ministry by splitting its aggregate allocations down to cost-center and account code levels. Once this is completed, the Budget Division of the Ministry of Finance (MOF), at the start of the budget cycle, distributes diskette files of the following to each ministry::

The detailed actual expenditure for the past two financial years

The appropriations and the revised estimates for the current year

The preliminary provisions for the budget year

Each ministry will then decide how the provisions should be distributed most appropriately among programs, activities, cost centers, and line items of expenditure. The individual ministry will upload its proposed budget to the MOF through BO\$\$, which will check whether the target allocations have been exceeded and highlight any significant variations. The highlighted aspects of the ministry's proposal will be analyzed and reviewed by the budget officers as the basis for preparing their reports for the annual budget review meetings between the MOF and the permanent secretaries of ministries.

Source: Joon Chien Doh, "Budget management and budgeting: The Singapore approach," in Naomi Caiden, *Public expenditure and financial administration in developing countries*, Jai Press, 1996.

F. Key Points and Reform Priorities

1. Key Points

The budget formulation process should aim at: (i) ensuring that the budget fits macroeconomic objectives and that expenditures are under control; (ii) allocating resources and programs in conformity with the government's policy objective; and (iii) assuring conditions for operational efficiency.

Hard choices and trade-offs must be made explicitly when formulating the budget. Postponing such decisions until budget execution does not allow a smooth implementation of priority programs, and is disruptive for program management.

The budget is the mirror of government policies. Mechanisms for formulating sound policies and ensuring the policy-budget link are essential. They include:

Coordination mechanisms for policy formulation within the government;

Consultations with the civil society;

Adequate means to the Legislature for scrutinizing policies and the budget (e.g. organization of Parliament committees);

Regulations to discipline policy formulation and reinforce the budget-policy link, notably (i) systematic review of resource implications of a policy change; (ii) superiority of the budget above other regulations, for fiscal issues; and (in some countries) (iii) regulation of powers of the legislature for amending the budget.

The preparation of a macroeconomic framework should be the starting point of budget preparation. The macroeconomic framework should show the fiscal targets (deficit, total expenditures, revenues, etc.). The degree of sophistication of projections depend on technical capacities within the country, but every country should frame the budget

preparation within a macroeconomic framework.

The macroeconomic framework should be based on realistic assumptions, without overestimating revenues or underestimating compulsory expenditures. It is necessary to assess continuing expenditure commitments and to identify measures for achieving the fiscal targets.

To commit the government explicitly and to establish accountability, the fiscal targets and macroeconomic projections should be published.

Financial constraints and policy choices must be built into the expenditure programming process. Budget preparation (and the preparation of any expenditure program) should be organized as follows:

A top-down approach which consists of: (i) defining aggregate resources available for public spending over the planned period, and therefore preparing a sound macroeconomic framework; and (ii) establishing annual sectoral spending limits that fit government priorities and notifying the line ministries of these spending limits;

A bottom-up approach which consists of formulating and costing sectoral spending programs for the planned period within the sectoral spending limits; and

Iteration and reconciliation mechanisms to ensure cohesion between these two approaches.

Budget preparation consists of the following activities: (i) preparation of the macroeconomic framework; (ii) preparation of a budget circular, which gives guidelines for the preparation of sector budgets and preferably announcing expenditure ceilings by sector; (iii) preparation of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the Ministry of Finance; and (v) finalization of the draft budget.

To choose among alternative programs and to prepare their implementation plan,

spending agencies need to know the amount of resources allocated to their sector. Spending limits should be announced early in the programming process. Since they are accountable for sectoral policy and performance, line ministries should be responsible for the preparation of their sector budgets, within the policy framework and hard financial constraints established by the government.

Countries where the conditions are conducive should consider the implementation of a multiyear expenditure programming approach.

The above weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Reforming budget processes is not a sufficient condition for addressing all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- As discussed in chapter 2, the coverage of the budget should be comprehensive, and decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions related to tax expenditures, lending, and guarantees and other contingent liabilities). This is required to optimize allocation of resources, and would limit conflict avoidance as well.
- Financial constraints must be built into the start of the budget formulation process, through the preparation of a fiscal framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policymaking coordination mechanisms that fit the country context are

needed, with particular attention to the budget-policy link. The fiscal impact of policy decisions must be systematically assessed (see section C).

- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority for designing these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting, see discussion in chapter 12).
- Line ministries should assess, when relevant to their mandate, the level of demand for the services they provide and changes therein

2. Directions of reform

The above weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Reforming budget processes is not a sufficient condition for addressing all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- As discussed in Chapter 2, the coverage of the budget should be comprehensive, and decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions

related to tax expenditures, lending, and guarantees and other contingent liabilities). This is required to optimize allocation of resources, and would limit conflict avoidance as well.

- Financial constraints must be built into the start of the budget formulation process, deriving from the preparation of a fiscal framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policymaking coordination mechanisms that fit the country context are needed, with particular attention to the budget-policy link. The fiscal impact of policy decisions must be systematically assessed (see section C).
- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority for designing these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting, see discussion in chapter 12).

Countries should develop appropriate policy *coordination mechanisms* that fit the institutional, constitutional, and political context. Participation of civil society through consultations mechanisms should be sought.

Budget preparation in every country should be framed within a *medium-term macroeconomic framework*, covering three to five years, to assess fiscal sustainability. The degree of sophistication of projections depends on technical capacities within the country, and could be progressively improved by the

development of economic models for macroeconomic forecasting. However, the development of these tools should not be a prerequisite for preparing a macroeconomic framework.

The macroeconomic framework should be supplemented by projections of aggregate expenditures by function and broad economic category, to assess its realism and to identify policy requirements and constraints in achieving the fiscal objectives.

Budget preparation should be organized along the lines mentioned above. Notifying initial spending limits early in the budget preparation calendar and increasing the responsibilities of line ministries in budget preparation are generally needed, although the implementation approach needs to be tailored to the country's institutional context. Close coordination in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from funds, etc.) is required, whatever the administrative arrangements. In countries where responsibilities for the capital budget are separated from responsibilities for the current budget, joint reviews of the two components of the budget are required at *each stage* of budget preparation and at each administrative level.

Budget preparation should be systematically placed into a multi-year perspective. This requires:

at least,

- developing the preparation of aggregate expenditures estimates by function and broad economic category along the lines suggested above;
- reviewing the forward costs of programs when preparing the budget

at a further stage

- preparing multiyear expenditure programs framed by a macroeconomic framework and strictly linked with budget preparation, and including only programs/projects for which financing is certain;

- ensuring that the multiyear programs focus on ongoing policies, and that new policies are decided only during the preparation of the annual budget;

As a final stage

- preparing a formal MTEF (see chapter 13) with the same coverage and in the same degree of detail as the budget (at least by program and projects, and broad economic category). To achieve this objective effectively a progressive approach can be considered. Aid-dependent countries should start by detailing the forward costs of investment projects financed by external sources (“Public Investment Program”; see chapter 12). Other countries could focus on the more costly items, e.g., entitlements, large investment projects/programs, or major specific sectors. These partial programs, as noted, must be framed by projections of aggregate expenditures, by function and broad economic category.

¹ We avoid the term “stages” because the process is also iterative, and a well-prepared budget consistent with policy objectives and financial requirements calls for extensive back-and-forth interaction between steps and between the persons involved.

² The reader versed in statistical inference will recognize here the familiar trade-off, for a given sample size, between the precision of a statistical estimate and its probability of being right, with narrow-band estimates being more precise but less likely to include the true value for the population, and wide-band estimates more likely to be correct but more vague as well.

³ Thus, the Philippines was led by the Asian financial crisis and the attendant uncertainties to move in 1998 from a quarterly cash release system to a monthly release system. Although not strictly applicable to the discussion here, which pertains more to expenditure programming than to budget execution, the example does illustrate the particular uncertainties affecting public expenditure management in developing countries.

⁴ Such a perspective has been referred to at various times as “indicative multiyear budgeting,” “medium-term public expenditure programs,” “multiyear estimates,” and “medium-term expenditure framework” (MTEF). The MTEF designation is currently used more frequently and will be used here as well. Also, an MTEF has a number of specific characteristics, described in the next section.

⁵ These concerns also force government to decide whether to contract out a service.

⁶ OECD, 1995.

⁷ “In Japan, where bargaining takes place in respect of the main budget account, greater controls are exercised by the Finance Ministry on the Fiscal Investment Loan Program, involving substantial borrowed funds and outside the traditional budget” (Premchand, 1983).

⁸ Budgeting by norms and formulae also reduces conflict, and has the advantage of simplicity. Whether it results in good allocation and efficiency depends largely on whether the formulae are appropriate and used to facilitate estimates and budget preparation, rather than mechanical straight jackets.

⁹ “Aside from the legacy of the planning practices of the past, other factors contributed to dual budgeting, such as pressure or recommendations from donors or IFIs. The desire of donors to “enclave” their projects, to minimize risks of mismanagement and maximize provision of counterpart funding, has also increased the fragmentation of the budget system. For example, at the recommendation of IFIs, Romania attempted in 1993-1997 to implement an investment coordination unit outside the Ministry of Finance, to prepare the capital budget and screen projects through its own investment department. A frequently debated issue in the World Bank is the tendency to “enclave...inherent in any project-centered approach to lending. But they reduce the pressure on government to reform, and they may weaken domestic systems by replacing them with donor-mandated procedures”, (World Bank, *Helping countries combat corruption*, 1997).

¹⁰ Sometimes, in countries with poor governance, the spending-developmental approach of the Ministry of Planning is opposed to the thrifty-financial approach of the Ministry of Finance. Again, reality is inconvenient: it is the financial authority that approves extrabudgetary loans, releases cash beyond spending limits, grants the guarantees, etc.

¹¹ See Tanzi (1995).

¹² What evidence does exist is in conflict with the hypothesis that separate investment budgeting has been fiscally expansionary. In 1990-1994, countries participating in structural adjustment programs had slightly *lower* capital expenditure relative to total expenditure, and higher current expenditure, than countries not undergoing adjustment. (Participating countries also had a much lower military spending and civilian wage bill.) This took place at a time when these countries were in effect required by the donors to have a separate investment programming process.

¹³ Adapted from Caiden and Widalvsky, *Planning and budgeting in poor countries*, 1990.

¹⁴ See Jeffrey M. Davis, *Macro-economic adjustment: Policy instruments and issues*, IMF Institute, 1992; S. Rajcoomar and Michael Bell, “Financial programming and policy: The case of Sri Lanka”, IMF, 1996.

¹⁵ Although the fiscal accounts may yield either a surplus or a deficit, the term deficit is used here for convenience and because it is in deficit situations that fiscal adjustment may become necessary.

¹⁶ When interest is rescheduled, the consolidated accounts established on a commitment basis do not show the amount of interest that must be paid in cash, since rescheduled interest is included. The presentation of the accounts should therefore include a memorandum item showing the interest and amortization to be paid.

¹⁷ See also B.H. Potter and J. Diamond, “Guidance for Fiscal Economists,” IMF, 1998, pp. 33-34 and p. 38.

¹⁸ See Tanzi, Mario Blejer and Mario Tejero, Effects of inflation on measurement of fiscal deficit: Conventional versus operational measures, in Blejer and Cheasty, 1993. This measure is not to be

confused with the "operating deficit", defined under accrual accounting as the change in net worth (similar to the notion of deficit in private business). These concepts are reviewed in Chapter 7.

¹⁹ Other deficit measures occasionally used are the "full employment deficit", i.e., the estimated deficit that would exist if the economy were operating at maximum capacity (theoretically measuring the purely cyclical component of the actual deficit), and the deficit including quasi-fiscal operations of the Central Bank.

²⁰ The deficit as an indicator of government solvency: Changes in the public sector net worth," in Blejer and Cheasty op.cit.

²¹ For a brief and readable summary, see the article by the main architect of the model, Jacques Polak, in the December 1997 issue of *Finance and Development* (see also Annex III).

²² For example, the RMSM-X, a model used by the economists of the World Bank. See case studies in Luc Everaert, Fernando Garcia-Pinto, and Jaime Ventura, A RMSM-X model for Turkey, World Bank, 1990; Luis Servén, A RMSM-X model for Chile, World Bank, 1990.

²³ National Audit Office, U.K., "Audit of assumptions for the July 1997 budget projections," presented to Parliament by the Chancellor of the Exchequer, June 19, 1997; Auditor General of Nova Scotia, Canada, "Report to the House of Assembly on the estimates of revenue for the fiscal year 1997-98 used in the preparation of the budget address," Auditor General's Office, 1977.

²⁴ Fiscal policy rules are presented in George Kopits and Steven Symansky, "Fiscal policy rules," IMF, 1998.

²⁵ See Tamim Bayoumi and Barry Eichengreen, Restraining yourself: Fiscal rules and stabilization," IMF, 1994.

²⁶ Binding targets must not be confused with the need to provide aggregate expenditure ceilings to all line ministries and agencies at the start of the budget preparation process.

²⁷ See OECD, *Budgeting for the Future*, 1997. The New Zealand Treasury notes in its presentation of the Fiscal Responsibility Act: New Zealand was changing its electoral system from a First Past the Post to a Mixed Member Proportional (MMP) system. This shift created inherent uncertainty over future fiscal management. The Fiscal Responsibility Act served to reduce some of this uncertainty."

²⁸ See R. Allen, *Assessing policies and their implementation: The United Kingdom experience*," in OECD, 1996.

²⁹ Or longer in the U.S.

³⁰ G.L.R. Dixon, "Budgeting institutions and expenditure outcomes in Australia, World Bank.

³¹ See Allen Schick, *Modern budgeting*, OECD, page 100.

³² "[In Australia] during the first five years of reform, ending with the 1989/90 financial year, Commonwealth spending declined from 29.8 percent of GDP to 23.7 percent. More recent data indicate, however, that the upward climb in public spending has resumed. Commonwealth outlays were 26.7 percent of GDP in 1993/94, three full percentage points higher than they were four years earlier. Without further investigation, one cannot determine whether this rise has been due to cyclical factors or to behavioral changes that emerged only after departments learned how to manipulate the new system to their advantage," Alan Schick, *The changing role of the Budget Office*, 1987.