

Chapter 6. ASSURING COMPLIANCE IN BUDGET EXECUTION¹

A. OBJECTIVES OF BUDGET EXECUTION

1. Importance of budget execution

Budget execution is the phase where resources are used to implement policies incorporated in the budget. It is possible to implement a well formulated budget; it is not possible to implement well a badly formulated budget. Good budget preparation comes first, logically as well as chronologically. However, budget execution processes do not come down simply to mechanisms for ensuring compliance with the initial programming. Even with good forecasts, unexpected changes in the macroeconomic environment will occur during the year, and need to be reflected in the budget. Of course, changes should be accommodated in a way that is consistent with the initial policy objectives to avoid disrupting the activities of agencies and project management. Successful budget execution depends on numerous other factors as well, such as the ability to deal with changes in the macroeconomic environment, and the implementation capacities of agencies. Budget execution involves a greater number of players than budget preparation, and calls both for assuring that the “signals” given in the budget are transmitted, and for taking into account feedback from actual experience in implementing the budget.

Hence, budget execution calls for: (i) ensuring that the budget will be implemented in conformity with the authorizations granted in the law, both in the financial and policy aspects; (ii) adapting the execution of the budget to significant changes in the macroeconomic environment; (iii) resolving problems arising during implementation; and, (iv) managing the purchase and use of resources efficiently and effectively. A budget execution system should ensure compliance with budgetary authorizations and should have adequate monitoring and reporting capabilities to be able to identify budget implementation problems promptly while giving flexibility to managers.

2. The budget execution system

A budget execution system should meet the three major objectives of a public expenditure management system, presented in chapter 1 (aggregate expenditure control, strategic resource allocation, and operational efficiency). Its procedures should be appropriately balanced to avoid or resolve conflicts between these objectives.

Aggregate expenditure control requires defining fiscal targets, and is therefore largely concerned with budget preparation (chapter 4). Budget execution procedures must therefore ensure that fiscal targets are effectively enforced and that managers comply with the budget authorized by the legislature.

The focus of traditional budget execution system is compliance, through detailed input controls to ensure that there will be no overruns and that the composition of the budget will not be altered during budget execution. This approach is aimed at assuring fiscal discipline, but generally poses two different sorts of problems. On the one hand, as noted earlier, excessively detailed controls are time-consuming, make the budget rigid, and do not give managers the flexibility needed to implement their budget efficiently. On the other hand, traditional controls are not even sufficient to assure fiscal discipline. They often focus on cash payments for supplies, while the most crucial problems are often found elsewhere (overstaffing, entitlements, arrears on utilities services consumption, etc.). For compliance, ex-post audits and sanctions and internal management systems are as important (and in many cases more important) than traditional budgetary control (internal control and audit is discussed in chapter 9).

1. To implement policies and programs in the most efficient and cost-effective way, the line ministries and agencies should be given adequate flexibility to manage their resources within the policy framework of the budget. This flexibility concerns the composition of the inputs needed to carry out a given activity and the allocation of resources among projects that meet the same set of objectives (within the same program). However, it should not alter the policies stated in the budget voted by the Legislature or hamper stabilization objectives.

2. Overspending and underspending

Overruns are sometimes caused by noncompliance of budget managers with the spending limits defined in the budget, when committing expenditures. Since cash allocated to spending units for appropriated expenditures is generally controlled, these overruns turn into arrears generation. Overruns are often the result of off-budget spending mechanisms (payments from special accounts, “below-the-line” accounts, etc.). In some countries, the expenditure process can be so cumbersome that “exceptional procedures” have been created to bypass them. Payments made through these exceptional procedures are not controlled against the appropriations and are therefore an important cause of overruns. Lack of compliance can be addressed through strengthening the audit system, and the reporting system, and ensuring the effectiveness of the basic budget execution controls reviewed below. A comprehensive coverage of the budget is required (see chapter 2). Exceptional procedures should be avoided, but in a number of countries this requires simplifying the system of control.

Overruns can be caused by deficiencies in budget preparation. Elements such as continuing commitments for investment and entitlements, or the impact of the inflation rate on wages are in some countries poorly taken into account when preparing the budget. Also, particular interests and political pressures may affect budget preparation, budget enactment and budget execution. In some countries, the executive or the Parliament adopts decrees and laws that have a financial impact on the budget even if they do not concern the budget directly. As discussed in chapter 4, regulations are needed in this area. The Ministry of Finance himself must review any regulation or draft decision that can have a fiscal impact. However, in some cases the Minister of Finance may cause the overruns (e.g., through spending from special accounts or unconsidered borrowing for projects). Sound budget preparation processes and adequate institutional arrangements are a prerequisite to avoiding overruns. But in some countries with bad governance, seeking solutions on the technical side could be illusory.

In a number of developing countries, the budget is underspent. This does not necessarily mean that there is good fiscal discipline in these countries. In some countries with bad governance, underspending of the official budget may coexist with off-budget spending. The underspending problem concerns the official budget and, particularly but not only, its development component. It is a very old problem. In the 1970s, expenditure plans prepared in a number of developing countries were underspent.² The execution of several development budgets and nonwage expenditure items in recurrent budgets currently present the same feature.

In a majority of cases, underspending, as well as overruns, is related to insufficiencies in budget preparation and program preparation. An overestimated budget and unrealistic projections of revenues lead to remaking the budget during budget execution. In a majority of developing countries, the Ministry of Finance is empowered to control the budget execution, through the Treasury and budget advisors/financial controllers. Therefore, when budget preparation is poor, insufficiencies in budget preparation are addressed through repetitive budgeting.³ After the budget is approved, the Ministry of Finance relies on its own views in preparing the budget implementation plan. A monetary committee reviews the revenue situation and may decide that only half of what the official budget actually calls for will be released. There is a budget but funds are released from a core budget known only to the Ministry of Finance, etc.⁴ Instruments that are required to ensure fiscal discipline and cash management can be disruptive to program implementation.

Concerning the development component of the budget, underspending is often related to insufficiencies in project/program preparation. Optimistic financial planning that does not take into account the time needed for procurement or for the mobilization of external funds is frequent. Development expenditures are difficult to plan accurately, but adequate flexibility to reallocate funds from projects that are delayed to projects that are proceeding well could allow satisfactory implementation of the overall expenditure program. Programming investment needs to consider the availability of domestic resources. Including projects in a development budget only on the basis of the availability of donor funds leads to an underspent development budget. Moreover, in some countries, cash-flow budgeting⁵ is a means for the Ministry of Finance to take

control over a development budget that it has not prepared. As discussed in chapters 3 and 4, close coordination between core agencies is imperative during budget preparation, to address any conflicting issues during this phase.

Any analysis of budget execution and the instruments for controlling budget execution needs to cover issues related to budget preparation, and to take into account both the risks of disruptive repetitive budgeting and the requirements for cash control and compliance control. The importance of these aspects depends strictly on each country context.

B. THE EXPENDITURE CYCLE

1. Stages of the expenditure cycle

Once the budget is adopted by the legislature, the expenditure cycle consists of the following phases:

- *Allocation of appropriations/release of funds to spending units.* Funds may be released through notification of cash limits, issue of warrant, funds transfers to imprest accounts, etc. In some countries, the release of funds includes two steps: (i) *apportionment* by the central budget office, which consists of defining which part of the appropriation the line ministries and spending decision units can use; and (ii) *allotment* by the line ministries and main spending decision units, which consists of allocating apportioned appropriations to subordinate spending units.⁶
- *Commitment.* The commitment stage is the stage where a future obligation to pay is incurred. A commitment consists of placing an order, awarding a contract, etc., for the services to be received. It entails an obligation to pay only if the third party has complied with the provisions of the contract. However, as discussed in section B2, the precise definition of “commitment”, in the budgetary sense, varies from one budget system to another, and depends on the economic category of the expenditure.

- *Acquisition/Verification (or certification)*. At this stage, goods are delivered and/or services are rendered and their conformity with the contract or order is verified. Assets and liabilities of the government are increased and recorded in the books, if the country has an accrual accounting system. Expenditures at the verification stage are called accrued expenditures in some countries (e.g. in the U.S.). Accrued expenditures should not be confused with full costs or other expenses for which certain appropriations within an accrual budgeting system are used (see chapter 10). Expenditure at the verification stage entails a liability, and arrears are the difference between expenditures at the verification stage and payments.
- *Payment*. At this stage, payments are made. Payments can be made through various instruments: checks, cash disbursed, electronic transfers, debt instruments, barter agreements, deduction from taxes, cash vouchers, etc. Payments through barter agreements, deduction from taxes and cash vouchers are questionable. Payments through deduction from taxes, are frequent in some FSU countries, but have negative consequences on both tax collection and competition among suppliers. Barter agreements impede competition among suppliers. Cash vouchers should generally be seen as an administrative stage in the expenditure cycle, rather than as a payment, especially when they are not paid immediately. Payments through checks are, in a majority of countries recorded when checks are issued. Comparisons with bank statements should be systematic. When the float of unpaid checks is significant, payments must be reported on the basis of checks paid.

[Please see attached Figure 8.xls]

2. What is a commitment?

In the budgetary jargon, depending on the nature of the expenditure and the country, a commitment (or an obligation) corresponds either to the commitment stage

as defined above, or to the verification/acquisition stage, or to an administrative reservation of funds in anticipation of their use. Some countries, e.g., the U.S., distinguish the (administrative) commitment" which is a reservation of funds, from the obligation, which corresponds to an order placed, contract awarded, service received, or similar transaction that will require payment.⁷

The distinction between the commitment stage and the verification stage concerns mainly investment expenditures and the purchase of supplies. For debt service, personnel expenditures, transfers, and also some categories of goods and services expenditures (such as electricity consumption, telephone), the commitment in the budgetary sense corresponds to the expenditure at the verification stage (monthly wage bill, interest payment due, phone bill). For these categories of expenditure, the obligation to pay comes from an event upstream to the commitment in the budgetary sense (disbursement of a loan, recruitment, phone call, etc.).

In budget systems, for multiyear contracts, a commitment, in the budgetary sense, may correspond to the commitment of the entire contracts, or to an annual tranche of the contract, or to actual expenditures. In this manual, when it is necessary to distinguish a multiyear commitment from its annual tranche, the expressions forward commitment and annual commitment are used. The legal commitment corresponds to the contract, not to the annual commitment.

C. ASSURING FINANCIAL COMPLIANCE

1. Who's in charge? Organizational aspects of budget execution

The decision to carry out a program authorized in the budget must be taken by the relevant line ministries, as is the case in most countries. However, in some countries, controls from the central ministries can interfere in sector policy.

There are also problems concerning the distribution of responsibilities between the central departments of the line ministries and their subordinate agencies. In some countries, continuous interference by the central departments in the management of

projects and programs impedes the effective implementation of these programs. In other countries, powerful agencies implement programs without reporting to their ministries. There is a need to clarify the distribution of responsibilities within line ministries to ensure that the central departments are fully responsible for coordinating sector policy and that subordinate agencies, projects, etc., carry out their activities under the supervision of the central departments without permanent and disruptive interferences from central departments in day-to-day administration. This last point is particularly important and difficult to solve in aid-dependent countries. The fact that projects are a pocket of prosperity within a destitute ministry often leads to the diversion of project resources to cover the running costs of the ministry's departments.

Budget execution covers both activities related to the implementation of policies and tasks related to the administration of the budget. Both central agencies and the spending agencies are involved in these tasks. The distribution of responsibilities in budget organization should be organized according to their respective areas of responsibility and accountability.⁸

The responsibilities of central agencies⁹ are the following:

- Concerning budget administration, administering the system of release of funds, monitoring expenditure flow, preparing in-year budget revisions, managing the central payment system (if any) or supervising government bank accounts, administering the central payroll system (if any), the consolidating accounts and preparing progress reports;
- Concerning policies, reviewing progress independently or jointly with spending agencies, identifying policy revisions where appropriate, and eventually proposing to the Cabinet reallocations of appropriations within the framework authorized by Parliament and the Legislature.

The responsibilities of spending agencies are the following:

- Concerning budget administration, allotting of funds among their subordinate units, making commitments, purchasing and procuring goods and services, verifying the goods and services acquired, preparing requests for payment (and making payments, if the payment system is not centralized), preparing progress reports, monitoring performance indicators, and keeping books,
- Concerning policy implementation, periodically reviewing the implementation of the program (including the monitoring of performance indicators), identifying problems and implementing adequate solutions, and reallocating resources among sector programs (but within the policy framework of the budget).

When several central agencies are involved in the supervision of budget execution, close coordination among these agencies is required and their respective functions should be clearly delineated. In particular, when the department responsible for administering payments is separated from the ministry responsible for budget preparation (the Ministry of Finance), and even when the Budget Department and the Treasury Department are attached to the same ministry, coordination between the departments responsible for budget preparation and execution is often insufficient. Budget revisions and reallocation of resources among sectors should be under the responsibility of the ministry and department responsible for budget preparation. The Treasury should provide them with all the needed information on budget execution.

2. Release of Funds

To ensure effective budget implementation, the authority to spend must be given to agencies on time. Funds should be released in conformity with budget authorizations. However, for cash management, the releases of appropriations must be regulated. Special issues related to cash management issues and the preparation of cash plans are reviewed in chapter 6. As discussed below, sound cash management does not mean “cash budgeting” or “cash rationing”.

a. Day-to-day cash rationing

In some countries, funds are released to line ministries through day-to-day cash rationing¹⁰ because of fiscal problems or an overestimated budget. Where a centralized Treasury system exists, this mechanism consists of an ad hoc selection of agencies to which cash will be transferred or a selection of the invoices to be paid. In some countries, this selection is made by a committee or a group composed of the Treasury Head, the Minister of Finance, and the Prime Minister. The “effective cash budget” formulated implicitly through this process is substituted for the authorized budget. Making budgets on a daily basis through such mechanisms violates informal contracts in budgeting, between the central agencies and the spending agencies, and the policy commitments stated in the budget.

Under cash rationing mechanism, funds are often released on emergency and political grounds, discarding the priorities defined in the budget. The budget resulting from these day-to-day decisions may be quite different from the budget approved by the Parliament. Moreover, cash rationing can not solve the problems it is meant to solve, since spending agencies can continue to make commitments according to the budget. They accumulate arrears, but comply with budget procedures. Such situations are (or were) met in several transition economies (e.g., China, Ukraine,).

b. Budget implementation plans and cash plans

To release appropriations, many countries slice the budget into four quarterly parts, or release one-twelfth of the budgeted amount every month, or prepare a budget implementation plan. Whatever method is adopted, the system for releasing funds should ensure effective and efficient implementation of the budget and avoid generating of arrears. Hence, the following elements need to be taken into account:

- To prepare the implementation of programs, agencies should know in advance the funds that will be allocated to them;

- Funds must be released in due time, without delay. In case of cash problems, the plan for releasing funds must be revised, but the revised plan should be communicated to the line ministries instead of making a nontransparent revision by delaying the release of funds.¹¹
- Particular attention must be granted to agencies located in remote areas. This needs adequate planning of the releases of funds and good coordination within the Ministry of Finance and/or within the line ministry between the central departments and regional offices.¹²
- Regulating cash flows without regulating of commitments generates arrears. In many cases when monthly cash limits are established, it is unclear whether spending units are allowed to make commitments up to the ceiling given in the budget appropriations or up to the monthly cash limits.
- Financial needs of ongoing commitments must be taken into account;
- Adjustment of commitments needs time. Imposing monthly limits is generally more of a regulation of cash through float than a regulation of commitments, since even for goods and services, a month may be too short to adjust commitments. In an emergency situation (e.g., as in Asian countries in 1998) or when budget preparation is insufficient, monthly cash limits are preferable to day-to-day cash rationing. If no measure is implemented to address the root of the problems, both mechanisms would generate arrears;
- An in-year distribution of payments related to investment expenditures is not steady and depends on various factors such as contractual payment schedules or, physical advancement of works.

In some countries, warrants are issued at the start of budget execution to authorize the government to implement the budget. These warrants are submitted to an ex-ante visa of the National Auditor.¹³ The relevance of this procedure is questionable,

since these warrants do not concern expenditure or cash release decisions, but only an allocation of funds already decided. However, these "somewhat ceremonial" or "pompous"¹⁴ procedures are purely formal and are not a factor of delay.

c. Sequestering

Sequestering is the cancellation of appropriations by the Ministry of Finance. The legislation should allow the Ministry of Finance to sequester appropriations to make clearly adjustments instead of adjusting cash plans. When sequestering appropriations, ongoing commitments must be taken into account. Although this instrument is needed in special circumstances, sequestering has the inconvenience of diminishing predictability.¹⁵

d. Release of cash within an accrual budgeting system¹⁶

Controlling cash on the basis of appropriations voted by the Parliament is ineffective in an accrual budgeting system. Appropriations for running costs include a provision for depreciation. If spending agencies are allowed to make payments up to the limit defined by these appropriations, total cash payments would exceed cash resources, or is the difference between appropriations and depreciation. Therefore, specific mechanisms that fit the nature of the appropriations must be implemented.

In New Zealand, both the Treasury and the Auditor-General perform an ex-ante external control on cash flows.¹⁷ Control makes use of accrual-based appropriation, a cash plan agreed between the Treasury and spending agencies, and monthly monitoring reports of the use of appropriations prepared by the departments and transmitted to the Treasury and the Audit Office.¹⁸ These ex-ante controls cover the global cash needs of a department, but are not specified by individual appropriations.

Within an accrual budgeting system, the preparation of cash plans and the control of cash releases need a strong accounting system since these mechanisms are not directly based on the appropriations. Central agencies (the "Ministry of Finance") must have adequate technical capacity to assess whether future depreciation would

cause appropriations to be exceeded or not. Such as a system could be difficult to implement in developing countries especially in countries where the budget processes are dominated by bargaining (see further discussions of accrual budgeting in chapter 7).

3. Compliance controls

The basic compliance controls during budget execution are the following:

- *At the commitment stage (financial control)*, it is necessary to verify that (i) the proposal to spend money has been approved by an authorized person; (ii) money has been appropriated for the purpose in the budget and sufficient funds remain available in the proper category expenditure; and (iii) the expenditure is proposed under the correct category.
- *When goods and services are delivered (verification)*, the documentary evidence that the goods have been received and that the service was actually performed must be verified.
- *Before payment is made (accounting control)*, it is necessary to confirm that (i) a valid obligation exists; (ii) a competent person has signified that the goods have been received and that the service has been performed as expected; (iii) the invoice and other documents requesting payment are correct and suitable for payment; and (iv) the creditor is correctly identified.
- *After final payment is made (audit)*, it is necessary to examine and scrutinize any expenditure and report any irregularity. Issues related to audit are discussed in chapter 9.

Generally within any organization, there is a separation of duties for authorizing expenditures, approving contracts and placing orders, certifying that goods have been received and that services have been provided as specified, and authorizing payments though some of these activities may be performed by the same person. In most cases,

however, the same person does not make the payment and perform the other activities or control them. This arrangement allows better internal control.

Within governments, this separation of duties may govern the distribution of responsibilities between the spending agencies and the core agencies (Ministry of Finance, Financial Comptroller, etc.). Depending on the country, controls may be either internal to the relevant line ministries or performed by a central ministry (Ministry of Finance, Financial Comptroller Office, etc).

4. Payment and Accounting Controls

Arrangements for payment processing and accounting control vary from one country to another. In many countries, a Paymaster Office is responsible for making accounting controls and payments. This office is also generally responsible for cash management, and forms the Treasury Department, but there are exceptions.¹⁹ In other countries, payments are processed by line ministries, but cash and bank accounts are controlled by the Treasury Department which is responsible for cash management. Therefore, issues related to whether accounting controls should be centralized or not, which are reviewed below, should be distinguished from issues related to cash management, reviewed in chapter 8.

a. Limits of accounting controls

Many budget systems focus on accounting control to ensure compliance. This approach is insufficient. Accounting controls can prevent blatant cases of misuse of appropriations. However, whatever their organization, accounting controls do not prevent the accumulation of arrears since obligations are made upstream. They do not prevent the commitment of expenditures that are not authorized in the budget.

b. Centralized external controls

Central payment systems ensure that accounting is done by a staff of qualified accountants, and allow the central agencies to see to it that payments are appropriately

documented and that every expenditure fits the purpose stated in the budget. This explains why such centralized controls are sometimes seen as the cornerstone of fiscal discipline.

In several countries, notably in transition countries, spending units maintain accounts with commercial banks and deal directly with their banks when making payments. This has the advantage of avoiding delays in payment processing that are caused by ex-ante external controls in some countries.²⁰ However, this arrangement could impede fiscal discipline since commercial banks could grant overdraft facilities to spending units and the Ministry of Finance cannot monitor payment transactions, and idle balances are kept in the bank accounts of line ministries. External controls between the spending units and the commercial bank or centralized payment system would be a good way solving this problem.

However, such approaches have inconveniences. Premchand, for instance, offers the following comments:

It may be recalled that some countries abandoned the traditional treasury systems as the banking system became more efficient. The spending agencies were given enhanced financial powers to issue checks and make payments through direct arrangements with the banks. The reintroduction of the treasury system would mean an expansion of the process, an increase in costs, and a curtailment of the responsibilities of spending agencies. Those who favor reintroducing the treasury system suggest that treasuries would not only scrutinize payments, but would also be responsible for compiling accounts. But such a step could widen the chasm between expenditure responsibility and the power of payment. Moreover, experience shows that treasuries are no less resistant to political pressures than are the commercial banks. Circumvention and politicization cannot be cured through the reintroduction of the treasury system. Rather, observance of discipline, which is an essential part of effective government financial management must be secured through tighter controls, periodic oversight,

strengthened accountability, greater citizen participation and, above all, greater transparency".²¹

In countries that have poor governance and face arrears accumulation, centralized payment systems increase distortions in budget execution. The officials of a central office have a wider range of opportunities to bargain invoice payments than the officers of line ministries or spending units. Supplier prioritization is therefore substituted for program prioritization.

c. Partly decentralized systems

When payments are processed under the control of central agencies (Ministry of Finance, Treasury, etc.), locating the accounting offices within the line ministries is preferable to locating them in a separate central treasury office. This reduces delays in processing invoices and requests for payment, and the risk of distortions in budget execution.

A system of revolving accounts or revolving cash limits, where funds are periodically released once the spending agencies produce statements and relevant documents of the payments made in the previous period, could accommodate requirements for accounting control and even reporting. In some countries, this system is used on a nationwide scale.²² This may present inconveniences for cash management. However, in developing countries that have poor infrastructure, such revolving-account mechanisms are required in remote areas. They are also required by IFIs for the management of the projects that they finance.²³

d. Reforming the organization of accounting controls

Many accounting controls and payment systems must be improved. Current centralized payment systems must evolve toward a better involving spending agencies and acquiring more flexibility. Current decentralized systems must better accommodate needs for monitoring, accounting, and cash management. They must be subjected to regular and comprehensive audits. The supervision of banking arrangements by central

agencies must be reinforced and cash balances must be centralized (see chapter 6). However, making radical reforms, which would mean centralizing a decentralized, system or vice versa, requires caution.

If elementary control procedures do not exist and the organizational arrangements are completely fragmented, building a centralized system is the more cost-effective solution to control cash. In other situations, the opportunity to centralize accounting controls and payment processing should be reviewed in relation to the objectives sought. Centralization of cash balances, central control of the government's bank accounts, and a sound reporting system are required. However, there is no need to submit invoices and requests for payment to a central office, and thus diminish the responsibilities of the spending agencies. If the main objectives are to diminish corruption and/or eliminate arrears, it is doubtful that these could be achieved by the centralizing of payment. There are risks of perverse effects. Central control of invoices does not prevent over-commitment, but on the other hand, may be an excuse to develop "exceptional procedures," which are very frequent in developing countries with highly centralized control systems.²⁴

On the other hand, replicating the model of countries that have decentralized payment systems in developing countries that currently use a centralized system could present inconveniences. Skilled accountants can be rare. Decentralization could increase difficulties in budget monitoring and cash management because of the lack of modern technologies. Decentralizing abruptly without the corresponding modernization measures could lead to a significant change in the payment system, creating significant disorders and loosening financial constraints.

To decentralize accounting controls and payment processing effectively, the following set of actions and reforms must first be undertaken: (i) reforming accounting and reporting procedures; (ii) training accountants; (iii) enhancing the audit system; and (iv) instituting measures to maintain the centralization of cash balances. The localization of accounting offices within line ministries (the partly decentralized system reviewed earlier) should generally be the first step before further decentralization.

5. Other ex-ante external controls

In a number of countries, commitment controls (financial control) are performed by a central agency. The objectives of such controls are to facilitate cash management and to allow the MOF to supervise budget implementation, but they lead to excessive interference central agencies in the day-to-day management of the line ministries' budget and may delay budget implementation. Ex-ante commitment controls should generally be avoided except depending on the context, for projects of a significant size (see discussion below on multi-year commitments).

In other countries, commitment controls are purely internal. Generally, agencies have to keep a commitment register. In practice, either this register is not systematically kept, or the commitment information exists but is not centralized and the MOF therefore cannot monitor budget execution. The decentralization of commitments gives required responsibilities to spending agencies in budget implementation, but requires an effective budget monitoring system (see section D).

Spending agencies in most countries make verification, although a few questionable exceptions exist.²⁵ The involvement of the Ministry of Finance in this activity should not be considered, but reporting at this stage is important, notably for an accurate assessment of arrears.

The benefits of multiplying controls are often barely perceptible in developing countries. Since ex-ante controls generally hinder efficient management because of bureaucratic procedures and multiplying checkpoints opportunities for corruption could also increase. "Tolls" or levies imposed in exchange for avoiding these checks limit the external controls.

Nevertheless, the main problem of ex-ante external controls is their effectiveness. Controlling commitments for personnel and investment needs specific tools, which are discussed below. Commitments related to entitlements, transfers, and subsidies are related to policy decisions. Even for goods and services, external

budgetary controls are insufficient. Controls on the consumption of goods and services from utilities, which absorb a significant part of recurrent budgets, need to reinforce internal management systems, not necessarily the budgetary procedures. In most situations, addressing compliance issues requires a broader approach than focusing on budget execution controls.

In several Asian countries, the Ministry of Finance assigns a Financial Advisor in each line ministry to control budget execution²⁶. The Financial Adviser, whose role and reporting requirements vary according to the country, is usually expected to identify budget implementation problems quickly. However, the system presents a significant inconvenience where the Financial Adviser makes sector budgets on behalf of the Ministry of Finance²⁷ or exercises cumbersome ex-ante control on the activities of line ministries.

In some countries, the officers responsible for performing accounting or financial controls report to both the Ministry of Finance and the heads of the relevant spending agencies. This system of dual responsibility may have inconveniences, since it does not set the clear rules for accountability and submits controlling officers to contradictory requirements.²⁸ However, it has the advantage of ensuring cooperation between the Ministry of Finance and the spending agencies, as well as by proper preparation of reports on budget execution.

External controls, when they seem unavoidable should focus on the major issues. They should be limited to control of compliance with appropriations and should not be concerned with the sector budgetary policy and sector implementation choices for programs already authorized by the budget. The responsibilities of the Financial Adviser, the Financial Comptroller and the Treasury Department should be established along these lines.

In several developing countries, the Ministry of Planning performs opportunity control of new projects at the start of budget execution or before the projects are launched. In some Asian countries, this has the advantage of limiting line-item controls on development expenditures,²⁹ but in other countries, these controls may be

superposed to the controls of the Ministry of Finance. Streamlining the project planning system would require: (i) deciding on new programs or projects when preparing the budget; and (ii) unifying the external control system and exercising a financial control instead of opportunity control during budget execution, if external controls during seem necessary at that time.

Comments made in this section call for greater decentralization in budget management for a majority of developing countries, but it should be noted that measures increasing the management responsibilities of line ministries in management must come with measures reinforcing the reporting system and audit. In a number of transition economies, the issues related to controls are different. Ex-ante controls are nearly nonexistent; reinforcing management control, reporting, and audit should therefore have the higher priority.

6. Monitoring forward commitments

The monitoring and recording of multiyear commitments could be necessary especially when the investment budget is significantly large. For countries, that finance their investments mainly from domestic resources, overruns are often due to badly estimated multiyear commitments in the budget. The usual multiyear expenditure programming tools such as the five-year plan and the classic PIPs in which new prospects are included in the second and the third years in an indicative manner, do not provide an adequate framework for administering these multiyear commitments. However, a multiyear expenditure program defined more restrictively (see chapter 13) could provide this framework, provide it is detailed enough to identify the activities that will be carried out through multiyear contracts.

To monitor and control these multiyear commitments appropriately, a ceiling for forward comments should be established could take the form of a commitment authorization included in the budget, a multiyear appropriation, or authorizations derived from a multiyear expenditure programming document (MTEF, PIP). The commitments are authorized up to these ceilings and should be reported in the same way as the uses of annual appropriations.

In non-aid-dependent countries that face overruns in the execution of the investment budget and do not prepare these authorizations or do not have adequate internal control systems, external control of multiyear commitments of a significant size cannot be dispensed with line ministries would have to submit a request to the Ministry of Finance, before committing to a contract of significant size. However, compared with controls based on formal commitment authorization, such ad hoc controls have the disadvantage of not distinguishing between financial control and policy or procurement control.

Generally, in aid-dependent countries, the problems met in executing multiyear projects are due more to insufficiencies in financial programming than to poor administration of forward commitments, since a significant share of the contracts is financed by external sources. A specific exercise in preparing commitment authorizations is less crucial in countries that finance investments from their domestic resources, but, as discussed in chapter 13, the preparation of a multiyear expenditure program is generally desirable.

D. BUDGET APPROPRIATION MANAGEMENT RULES

1. Annual nature of appropriations

Although there are exceptions, notably where some appropriations are obligation-based (e.g., in the Philippines), a classic rule of the budget is the annual nature of appropriations. At the end of the year, unused appropriations are cancelled. The adverse effects of this system are many. Revolving funds or extrabudgetary funds are set up, ad hoc private organizations are created to manage the budget under more flexible rules, etc. Concentrating the payments at the end of the fiscal year may be the result of cautious planning of commitments. However, the annual rule can also create a rush for spending at the close of the fiscal year, variously described as spree spending or squander mania³⁰. To ensure that appropriations are maintained at the same level the following year, line ministries can make unplanned spending at the end of the year.

A spending bulge at the end of the fiscal year may only reflect commendable prudence on the part of a ministry that is concerned with keeping its expenditures down as much as possible throughout the year, as protection against unexpected mid-year cuts in appropriations. In this case, a carry-over provision may be unnecessary and could possibly raise some problems in certain countries. When the year-end spending bulge is related instead to a weak budget preparation process that has accommodated inflated requests, the spending is likely to be for nonpriority or even wasteful purchases. In these circumstances, the optimal response would be to improve budget preparation; however, a carry-over provision can serve as a second-best mechanism, to remove the temptation to get rid of leftover funds before the spending authority comes to an end. The latter is likely to be the case for at least some spending agencies in most countries. In any event, rushed expenditures almost invariably requires some avoidance or bending of the procurement rules, which is not a practice to be encouraged. On balance, therefore, it appears that a small carry-over provision can provide additional flexibility at a negligible cost in terms of the integrity of budget execution.

Generally, Ministries of Finance fear that abandoning the annual rule would hamper fiscal balances and cash fiscal deficit objectives. However, expenditures carried over from the previous year could be balanced by expenditures carried over from the current year to the following year. Moreover, rules to keep carrying forward under control can be specified to take the country's context into account.

In some developed countries (e.g. Australia), the annual nature of the appropriation has been altered recently to authorize the carry-over of up to 10 percent of current expenditures. In several countries, the carry-over of capital expenditures is authorized or requires only an approval of the Ministry of Finance.

Systematically authorizing carry-over in developing or transition countries could pose problems, as regards expenditure control, especially where the budget is not prepared on realistic revenue forecasts. However, authorizing carry-over could also avoid the perverse effects of the annual rule. Alteration of the annual rule is desirable in developing countries, provided that expenditure and revenue estimates are realistic.

Some safeguards are needed. Procedures for carry-over should be implemented progressively, to ensure that they do not hamper expenditure control, and submitted to the approval of the Ministry of Finance. as a first step, they could be concerned with investment expenditures, which are difficult to manage within an annual budget framework. Appropriate procedures are also needed for paying bills and invoices that were regularly committed over the previous fiscal year, but have not yet been paid because delays in deliveries, for example.

2. Transfers between line-items (virements)

Rules for transfers between line items (or “virements”) are generally stated in the financial regulations (or in the budget organic law; see Annex IX). They distinguish before virements that may be made freely by line ministries, virements submitted to an approval of the Ministry of Finance and virements that are strictly forbidden. Often, control of virements is one the major activity of the budget offices during budget execution. This procedure is time consuming and excessively absorbs administrative resources.

Spending agencies need flexibility in implementing their budget. An investment project may be delayed for technical reasons, while another should preferably be speeded up. Determining the exact composition of the inputs of a program would be difficult. As indicated in chapter 2, several OECD countries have recently implemented block appropriations. Line ministries are free to determine the best composition of inputs to implement their programs and achieve results.

To achieve efficiency, line ministries must be give a certain degree of freedom to allocate resources within their sector. However, this freedom should not hamper fiscal discipline or the priorities defined in the budget and voted by Parliament.

78. Concerning transfers between objective of the same program, it would be difficult to adopt in developing countries or transition economies the system of block appropriations adopted in some OECD countries. Depending on the internal capacities of line ministries to control their program and the nature of problems met in budget

implementation, it may be necessary to either protect or cap some object items through a regulation of virement. Typically, virement between personnel expenditures and other economic categories needs to be regulated in many developing countries. However, the effects of these regulations need to be carefully reviewed to ensure that they are designed properly. In some countries, switching from other economic categories to personnel expenditure is forbidden; in other countries, switching items from personnel expenditures to other economic categories is forbidden. In the first case, regulations for virements aim at capping personnel expenditures. In later case the regulations aim at protecting personnel expenditures. Capping has the advantage of giving a clear signal to spending agencies. However, protecting expenditures already committed can be preferable to limit budget overruns and arrears generation.

In some countries, it may be desirable to have rules either to protect some nonwages items for which arrears are frequently generated (such as electricity consumption) or on the other hand to cap some categories of expenditures (e.g., mission of ministers abroad). However, these rules should focus on what is necessary and should not apply forever. What can be a problem of compliance one year will not necessarily be a problem the following year.

During the budget implementation of programs, certain problems can occur, particularly when it comes to investment expenditures. In this case, appropriate measures must be taken budget resources must be reallocated budget resources from problem projects to other projects to ensure that government policy objectives are effectively implemented despite the difficulties. In some countries controls of virements performed by the Ministry of Planning are made at the project level and are too detailed.

However transfers between programs or projects must not alter the policy framework adopted by the Parliament. For instance, the Ministry of Education should not be authorized to reallocate freely budget funds from primary education to higher education. Transfers between programs or between administrative units that alter the budget policy as adopted by the Parliament should be forbidden or strictly regulated.

82. Transfers between the budgets of line ministries need to be regulated by the center of government and submitted to the Cabinet, for obvious management reasons.

3. Expenditures financed by external sources

83. As indicated in chapter 2, expenditures financed will project aid should be budgeted. Obviously, appropriations for grants need to be indicative. It is necessary to setup procedures to authorize the contracting of loans and, to control indebtedness and therefore the total amount of each loan. However, annual estimates for drawings should be indicative. The impact of a project loan on debt service depends basically on the total disbursed amount of the loan. The annual distribution of disbursements over the project implementation period affects only the interests during construction.

4. Issues related to nonbudgeted expenditures and unfunded liabilities

84. Liabilities are defined as debts and obligations to pay resulting from past events. Issues covering debt management and other future liabilities are reviewed in chapters 8 and 10. In some countries, a distinction is made between funded and unfunded liabilities, the difference being whether or not resources to finance the related expenditures have been budgeted. In some countries, it is argued that the unfunded liabilities should not be paid, since the expenditure was not authorized by the legislature. However, unfunded liabilities may correspond to legal obligations that the government cannot ignore.

Therefore, sometimes these unfunded liabilities are paid, but the executive waits for the following budget to regularize them. As a result, in the budget execution reports, expenditures of the current year are underestimated, while the budget of the following year includes appropriations for expenditures already made. Measures to improve the management of unfunded liabilities depend on their causes. Unfunded liabilities not related to a lack of compliance include, notably, the following liabilities.³¹

- *Liabilities arising from legislative changes.* Legislation after the start of the fiscal year may augment existing benefits. Regulations should be established to eliminate or at least limit the generation of such liabilities.
- *Compulsory indemnities.* The legislation may include provisions for compensating losses caused by special events, for example, to compensate disaster victims. The government can be sentenced to pay judicial indemnities, or may have to indemnify contractors because of a breach of contract, etc. For miscellaneous indemnities, a reserve could be included in the budget to limit unfunded expenditures.
- *Exceptional expenditures* that are not included in the budget or that cannot be estimated accurately when preparing the budget. The country may face natural or environmental catastrophes, which cannot be forecasted when preparing the budget. Expenditures for major policy actions may be difficult to estimate, for example, expenditures related to a banking sector restructuring program. Expenditures related to these liabilities must be shown in the budget execution report, and the year-end report, and posted in the accounts. In some countries this may require revising procedures and legislation. An in-year budget revision should be made systematically to include exceptional expenditures in the budget.

Besides the cases mentioned above, some unfunded liabilities are related to lack of compliance. An appropriate and effective system of sanctions is needed. However, these liabilities may have to be recognized, if the contracts are regularly committed with respect to the commercial, and the government's legal procurement framework. Issues related to hidden liabilities such as unfunded pension liabilities are reviewed in chapter 10.

¹ This chapter is separated from the following one on managing budget implementation for the reader's convenience. However, the two chapters should be seen as part of the same overall process & budget execution.

² See, for example Aaron Wildavsky, Why Planning Fails in Nepal, *Administrative Science Quarterly* 17, 1972.

³ See Caiden and Widavsky, 1980, 1990.

⁴ See Caiden and Widavsky, op. cit. and discussion of the "core budget" in chapter 4 of the present volume.

⁵ See Caiden and Widavsky, op. cit..

⁶ U.S. terminology (Schick, *the federal budget process*).

⁷ A. Schick, op. cit.

⁸ See chart in Premchand, (1983), page 259, which lists "budgetary tasks" and "administrative tasks." The distribution of tasks suggested below is partly drawn from this chart.

⁹ In many countries this expression covers several organizations, such as the Ministry of Finance, the Treasury, the Financial Comptroller Office, or the Ministry of Planning.

¹⁰ As in Ukraine in 1976.

¹¹ These mechanisms for fund release in the various Asian countries do not always ensure that funds are released in due time for use by the spending authorities. Delays in authorization may be intentional, with the Finance Ministry withholding release orders if they are uneasy about the Ways and Means position of the government. The Finance Ministry may indeed make some informal reprioritization of expenditure of its own (ESCAP, 1993).

¹² "In the pre-computer age, which still prevails in some Asian countries [e.g., Nepal until 1997], there were frequent logistic problems over fund release when spending agencies had to make repeated visits to the Controller's office, particularly in the districts which claimed that authorization had not reached them from the Finance Ministry, the line ministry or the head office of the Controller" (ESCAP, 1993).

¹³ E.g. Turkey, New Zealand and some other Commonwealth countries.

¹⁴ Premchand, 1983.

¹⁵ A discussion of the inconveniences of sequestering may be found in Sylvie Hel,-Thierry and Yves, Meny-Alain Quinet, *Decision-Making and the Budgetary Process in France*, OECD, *Policy and Decision-Making*.

¹⁶ This paragraph is drawn from Scott, 1996.

¹⁷ See Scott, 1996.

¹⁸ Financial management policy guideline no. 8, The Controller Function, New Zealand Treasury, 1989. quoted in Graham C. Scott, *ibid*.

¹⁹ As in Turkey, the accounting offices which process payment report to the Ministry of Finance, while the Treasury Department, responsible for cash management and centralizing government bank accounts, is an independent body. In Sweden and several other OECD countries, cash management is centralized but accounting controls are performed by spending units.

²⁰ "Another area of strength [of the budgetary systems of transition economies] is the relative abridgement of the payment process. "The assignment of a bank to a spending agency has reduced the red tape and the numerous steps of verification associated with a number of other systems" (A. Premchand and L. Garamfalvi), *Government accounting systems in Tanzi*, 1995.

²¹ A. Premchand, 1995, page 41.

²² As in Nepal (but officers responsible for accounting controls report to both the Financial Comptroller and the Head of the spending agencies).

²³ Such as "Special accounts" for projects financed by IFIs.

²⁴ As in African countries with the French system.

²⁵ As in Cameroon

²⁶ As in India, Malaysia, etc.

²⁷ Where the Budget Office as in Turkey control both budget preparation and budget execution.

²⁸ The functions, duties, powers and responsibilities of the accounting officers working in the ministry department/office/project are nowhere clearly specified. It is difficult to assert with finality whether they are responsible to the high-ranking officers of their known faculty, or to the office chiefs or to the Comptroller General" (Report of the administrative Reform Commission, Government of Nepal. 1992).

²⁹ Premchand, 1983.

³⁰ Premchand, 1993. This practice was standard in the Soviet system and was called *shturmovschin*.

³¹ The list of these liabilities is drawn from Premchand, 1995,