CHAPTER 3. BUDGET SYSTEMS AND EXPENDITURE CLASSIFICATION

A. APPROACHES TO BUDGETING

Different countries have taken different approaches to, and several traditions exist, each with its specific features consistent with the overall administrative "culture." The following should be read with this basic consideration in mind, although it is intended to describe generally valid principles and common ground.

1. Nature of legislative authorizations

a. Basis of appropriations

The nature of the authorization granted by the legislature depends both on the budget system and on the nature of the expenditure. Although there are exceptions (notably "permanent authorizations"), these authorizations are granted through appropriations, which are specific authorizations enabling the government and its agencies to spend money. The legal basis for appropriations is normally provided in statutory law. Such law should, however, avoid excessive detail, and procedural guidance should be provided by administrative law in order to permit incremented reform.

Appropriations may be grouped into the following broad categories:

- *Obligation-based appropriations* give rights to make commitments and to make cash payments according to these commitments, *without a predetermined time limit*. Such appropriations have their own life cycle and are not limited to one year. This system is no longer used for all expenditures, but may be used for special programs (e.g., in U.S., Philippines, or Micronesia).[1]

- *Cash-based appropriations* give authority to make cash payments *over a limited period of time*, generally corresponding to the fiscal year. This system is the most widespread. In principle, appropriations define cash limits that cannot be exceeded, but there are exceptions. At least for goods and services, they correspond also to a limit of entering into contractual commitments. They cover the *payments due*. In a few countries (e.g., the U.S.), the budget for a few selected programs includes multiyear budget authorizations.

- *Accrual-based appropriations* cover *full costs*, for the operations of a department and other increases in liabilities or decreases in assets (called expenses by accountants; see chapter 10). Full costs are the goods and services consumed (as opposed to acquired) over a period. Therefore, depreciation for physical assets, variations in inventories and variations in liabilities are added to actual payments to calculate the full costs of a program (see figure 10 in chapter 10).[2]

For personnel expenditure, accrual-based appropriations can also cover pension superannuation liabilities. For a subsidized loan, an accrual-based appropriation covers the actuarial value of the interest subsidy. For assets of national interest (i.e., roads), an accrual-based appropriation can include depreciation of these assets.

The distinction between assets of national interest and assets owned by a department is an important element in determining the running costs of a department, and consequently the appropriation for the activities of this department. In the same way, depreciation of assets shared by different programs must be divided among the programs. Determining full costs of a program requires adequate costs measurements systems (see chapter 10).

Figure 1 compares appropriations, commitments, and payments along these three categories of appropriation.

[Please see attached Figure 1.xls]

b. Authorizations for multiyear programs

A few countries (e.g. France) include in their budgets, aside from cash appropriations, *authorizations for forward commitment* for some categories of expenditures (mainly for investment). These authorizations for forward commitment authorize commitments covering a multiyear period, but annual appropriations are still required to make payments. In some developing countries, these are shown in the development/investment budget (e.g., Indonesia). They differ from *obligation-based appropriations* which also cover multi-year programs but are authorizations to pay as well as to commit.

In other countries, these authorizations for forward commitment are not included in the budget but are prepared by the government for internal management purposes. For example, in Australia they are defined as a share of the multiyear estimates (see chapter 13) and are approved by the Cabinet. In a few countries (e.g., the U.S.A.) the budget includes multiyear cash authorizations for some programs.

c. Permanent appropriation/authorization

Several countries include in their budgets permanent appropriations or authorizations for debt service, entitlements, etc., which is explained by the nature of obligations related to these categories of expenditures. As these expenditures are legally mandatory and recurrent, a different budgetary treatment is understandable. In some countries, for constitutional reasons, salaries of judges are permanent appropriations and are not submitted for legislative approval. However, generally the estimates of relevant expenditures that are to be incurred over the fiscal year are shown in the budget. This is required, whatever the nature of the authorization.

Some countries (e.g., France) distinguish between *restricted appropriations* which give a specific limit and *approximate appropriations* which cover expenditures that are obligatory but cannot be forecasted accurately (such as debt servicing).

d. Gross terms

As indicated above, to formulate and assess correctly the government policy and its activities—including its business activities—expenditures and revenues should be shown in the budget in gross terms, even if the authorization of the Parliament and the budget execution controls concern only netted appropriation (i.e., expenditures that exceed commercial revenues).

e. Annual rule

Budgets are almost always annual (although the “fiscal year” can be the calendar year or some other 12-month period). A shorter period would be disruptive for management; a longer period would be subject to an increasing margin of uncertainty. However, some programs are multiyear and, generally, making shifts in the composition of the budget needs time. The annual framework is generally insufficient for resource allocation and should be supplemented with specific procedures for multiyear commitments and multiyear expenditure estimates (discussed in chapter 13). The annual rule also induces distortions in management when strictly applied and when the carrying forward of expenditure is strictly forbidden (see chapter 6).

2. Basis of the budget

Budget systems can be classified according to the basis of appropriation defined earlier in section 1.a.

a. Cash Budgets

A cash-based budget is a budget where most of the appropriations are on a cash basis. Therefore, in a cash-based budget, appropriations define limits for payment and annual commitment, that is, financial obligations met within the fiscal year and the annual tranche of multiyear commitments (see chapter 6 for a discussion of what is a commitments).

A cash budget fits well the need for compliance and expenditure control. Commitments and payments are controlled on the basis of the authorizations of the Parliament. Macroeconomic objectives, such as the cash deficit, are directly linked to the appropriations.

b. Obligation-based budget

In an obligation-based budget, appropriations define cash and commitment limits, but for certain, there is no time limit for payment. An obligation-based budget needs to be complemented with an annual cash plan for the appropriations that are obligation-based.

c. Accrual-based budget

An accrual-based budget can be defined in two ways:

- A budget where appropriations are on an accrual basis and are *not* a limit for cash payment or commitment (e.g., the New Zealand budget). Cash payments are controlled, but through separate means rather than on the basis of the appropriations (see chapter 8).

- A budget that presents accrual information and projections of the balance sheet of the government, but where appropriations also define cash limits. Many budgets of local governments in developed countries are presented along these lines. In Iceland, the budget is presented both on cash and on accrual basis.

Generally, the term “accrual-based budget” refers to the former definition, which is adopted in this volume except where specified. Hence, cash payments and commitments cannot be controlled directly from accrual-based appropriations and separate additional mechanisms must be put in place to control cash.[3]

For appropriations, the distinction between cash-based and accrual-based budgets concerns mainly pensions, running costs and in New Zealand, other items such as “purchase of national assets (e.g. national parks, highways, parliament buildings)”. Currently, in New Zealand, transfers and “capital contributions to increase in investment in a department” remain appropriated on a cash basis.[4] With respect to interest, there is no difference between an accrual-based appropriation and a cash-based appropriation.[5]

An accrual-based budget is aimed at fostering performance. Since full costs are budgeted, agencies have strong incentives for assessing their costs. On the other hand, the presentation in the budget of accrual information on liabilities or interests subsidies presents advantages for transparency and policy formulation. These two advantages are distinct, since improving the budgetary treatment of financial liabilities and subsidies does not require including depreciation into the Parliament’s authorization.

Despite these advantages, attempting to implement accrual budgeting in developing and transition countries would pose major problems. Before thinking of abandoning a cash budget system, the following elements must be considered:

- Accrual budgeting alters the traditional rules for compliance. Parliament’s authorizations would not be cash-commitment-based and would include depreciation. Moreover, for good services, there may be a time lag between the acquisitions and the payments, on the one hand, the consumption of goods acquired and the uses of appropriations on the other, (see chapter 10 for a more detailed discussion). Therefore, if appropriations are established on an accrual basis, it is essential to establish additional mechanisms for ensuring that cash is kept under control, both in budget preparation and in budget execution. Accrual budgeting has proven to be neutral or even good for fiscal discipline in New Zealand, since this country has effective internal cash controls also. In other countries, accrual-based appropriations must be seen as an abandonment of cash controls and therefore opening a new door to misappropriation and corruption.

- Accrual accounting presents advantages (see chapter 10). Accrual accounting does not necessarily mean accrual budgeting although there terms are commonly confused. Accrual budgeting requires accrual accounting, but developing an accrual accounting system does not require abandoning the cash-based budget (e.g., the U.S. has implemented recently a full accrual accounting system, but has maintained its cash-budgeting system).

- Requirements for "full" accrual accounting, which is a prerequisite for accrual budgeting, are heavy, and a progressive approach to improving accounting would be to focus first on financial liabilities (i.e., to implement what is called a "modified accrual accounting system").

- Improving cost measurement and assessing full costs is desirable. However, this is not easy and full cost estimates cannot be very accurate at the start. In developing countries, it would be quite questionable to begin with a government-wide exercise and define the use of appropriation on the basis of rough depreciation estimates.

Developing and transition countries should focus on consolidating their cash budget, improving their system for tracking the uses of appropriations (see chapter 6), and gradually improving their accounting system (see chapter 10). As discussed in chapter 15, they could also introduce some elements of performance orientation, as appropriate (not performance budgeting), but this does not at all require a change in the nature of appropriations.

Box 10
Clarifying Some Terms

A few years ago, the adjective accrual was often used in budgetary jargon to define expenditures at the delivery/verification stage. Currently, accrual is defined as in the Generally Accepted Accounting Principles (GAAP) of the accountants' profession. Therefore, the following the areas of confusion should be avoided:

- Expenses versus accrued expenditures. For operating costs, a budget on an accrual basis is does not show accrued expenditures. It shows accrued expenditures plus depreciation plus/less variations in inventories and losses plus/less advance payments.

- Accrual accounting versus "accrued) expenditures accounting. The expression expenditures accounting" which has been used in some countries, refers to the registration of expenditures at the delivery/verification stage. Monitoring expenditures at this stage is a key element for sound budgeting, and is strongly recommended, but if is not accrual accounting. (In theory, accounting for expenditures at the delivery/verification stage is the only way of assessing the arrears accurately. Accounting only for commitments over estimates arrears.)

- Accrual accounting versus modified accrual accounting. Some accounting systems that were called accrual accounting systems in the early 1980’s should now be called "modified accrual accounting system" (see chapter 10), as "accrual accounting" for government corresponds today to commercial accounting. In this volume, the expression full accrual accounting is used instead of accrual accounting when necessary to avoid any confusion between “accrual” and “modified accrual.

- Operating deficit (deficit on an accrual basis) versus deficit on a commitment basis. A commitment refers to an order placed or a contract awarded. In budgetary jargon, the deficit on a commitment basis is often similar to the deficit on a cash basis plus change in arrears. It does not at all correspond to the operating deficit defined by accrual accounting principles (see chapter 10).

3. The traditional approach: Compliance budgeting

A major aim of the traditional budgeting system is to make the budget a tool for financial compliance. A cash-budget fits this aim.[6] Within the budget, expenditures are classified by organization and object of expenditure (line item), e.g. transportation of things, full-time personnel, etc., to control the use of resources. Budgets prepared in this way are often very detailed and in some countries include several thousand line items.

Line-item budgets were (and in a number of countries still are) associated with an "input-oriented" budget preparation with detailed ex-ante controls and/or rigid appropriation rules (e.g. rules regulating or forbidding transfers between line items). However, these aspects can change country by country. In a number of countries, the control system is aimed only at avoiding transfers between personnel expenditure and other items, and detailed line items may be included in the budget for information only. Therefore, one should not confuse a justified criticism of an excessively detailed and rigid line-item budget with criticism of line-item budgeting itself.

A major criticism of the traditional budget system is that it does not deal with key issues of government objectives, their links to the budget, the services to be delivered by the government; the search for the most efficient combination of inputs to deliver services, etc. Thus, since the early 1950s, various performance/program budgeting reforms in both industrialized and developing countries attempted to address these issues. As reviewed briefly below, the results of these reforms have been usually disappointing compared with their costs, and in a few cases even counter productive.

In the 1980s, the focus changed to macroeconomic stabilization, and budgetary reforms were essentially aimed at making the budget an effective tool for fiscal policy. Several developing countries still imported performance/program budgeting approaches (with generally poor results), but PPBS was no longer the dominant international paradigm. As long as it is comprehensive and includes an appropriate economic classification, the traditional budget format fits well the requirements for macroeconomic stabilization. Currently, performance-oriented budgeting approaches are regaining popularity.

4. Performance/Program budgeting[7]

It is fundamental not to confuse performance orientation in the budget system, which can be fostered in a number of appropriate ways, with the specific system known as *performance budgeting*. In performance budgeting, the budget shows the purposes of the expenditure, the costs of the "programs" proposed for those purposes, and measurements and results under each program. Therefore, performance budgeting includes the following features:

- Government activities are divided into broad functions, programs, activities, and cost elements. A "function" corresponds to a broad objective of the government (e.g., promotion of agriculture). A "program" is a set of activities that meet the same set of specific objectives (e.g., development of crop production). An "activity" is a subdivision of a program into homogenous categories (e.g., irrigation project). Cost elements are the inputs, and costs are measured on an accrual basis. A criterion used to delimit the activity category is the level at which performance indicators can be elaborated and costs measured. The operational aims of each program and activities are identified for each budget year.

- Performance indicators and costs are established, measured, and reported. (In the 1950s, the aim was to establish standards and norms, again with highly doubtful impact.)

The hierarchy of "function," "program," and "activity," is comparable to that of the government structure ("ministry," "directorates," and "divisions" or projects). But there is no systematic relationship between the functional structure of the budget and the organizational structure of government. Indeed, a major problem with program budgeting is the disconnect between the program structure and the administrative structure[8] and the resulting complexity, lack of "ownership", and loss of accountability. Figure 2 shows the relationship between program/activity categories and other classifications.

[Please attached Figure 2.xls]

The first experience with performance budgeting on a wide scale was launched in 1949 in the U.S., following the recommendations of the Hoover Commission. Emphasis was put on full cost measurement, evaluation of workload, and unit costs. The 1951 U.S. budget included listings of the programs or activities by budget account and narrative statements of program and performance, some of them presenting workload and cost information, calculated on an accrual basis. The experiment was a failure and the U.S. abandoned it soon thereafter, although some of the lessons learned proved useful later and were incorporated into the budget reforms of the 1990s.

A generation before the emergence of the “New Public Management” (see annex V), a performance budgeting experiment was launched in 1954 in the Philippines, following the U.S. example. For fiscal year 1956, twelve government agencies adopted a performance budget model; detailed line items were abandoned and expenditures were presented in the budget by blocks corresponding to programs and projects. The system reverted back to the more traditional model, as a result of the constant complexities of the “performance budget” and some loss expenditure control. Currently, the resulting presentation is basically for information, showing capital and current expenditures for each agency and subordinate spending unit and performance indicators. The preparation of budget submissions focuses on programs rather than on line items. However, these changes in the budgetary decision-making process are more formal than real.

In the U.S., by 1964, 80 percent of federal agencies provided cost information in their budget requests. However, the need to take into account also the qualitative aspect of expenditure led to the Planning Programming Budgeting System (PPBS), launched in 1965. PPBS aimed at ensuring a better linkage between objectives and goals, programs and activities. In the planning phase, systems analysis was used to establish the objectives and identify related solutions. At the programming stage, means were reviewed and compared to the solutions identified at the planning stage. Sets of activities are grouped into multi-year programs, which are appraised and compared. Finally, the budgeting phase translates these programs into the annual budget.

The initial objective of PPBS was to integrate program budgets into budgetary decision making and to overcome administrative compartmentalization by making programs independent of organizational affiliation. PPBS proved impossible to implement not only because of (predictable) bureaucratic resistance, but because reaching a perfect and indisputable rational organization of government objectives and activities is illusory. In addition, this approach muddled up ministers responsibilities and hampered accountability.[9] Program budgeting and PPBS-like approaches were attempted over and over again in many developed countries in the late 1960s and the 1970s, but generally not for long and were abandoned in the 1980s.[10]

In the late 1970s, another experiment—Zero-Based Budgeting (ZBB)—was attempted in the U.S. as a reaction to the drawbacks of purely incremental budgeting (see Chapter 4). In a pure ZBB system all programs are evaluated each year and must be justified from scratch. The fact that resources have already been granted to a program does not necessarily mean that it must be continued. The ZBB approach is useful for occasional expenditure reviews, but is practically impossible to undertake each year for the preparation of the annual budget. In actual fact, ZBB was accommodated by focusing scrutiny on a few marginal programs. In any event, the U.S. Congress decided to review the traditional budget presentation and put aside the voluminous and complex ZBB documentation.

In developing countries, attempts to introduce program budgeting and systems to manage were been pursued in the 1980s, rarely drawing on the lessons of experience of the previous decade, and usually with the encouragement (or pressure) of international donors and enthusiastic endorsement of international consultants[9]. In Asia, aside from the Philippine experiment mentioned above, experiences in program/performance budgeting were carried out in India, Malaysia, Singapore and Sri Lanka. Results were uneven, and far from the initial ambitions of the proponents of the PPBS system in the 1960s. Experience was similarly unfavorable in Latin America (Petrei, 1998). As a result, (and probably for good reason) in developing countries where program budgeting was introduced, it has typically been sidelined and its role sharply reduced compared to the initial design. Quantitative program goals are defined, but "play no role in budget discussions, nor are they used to monitor the use of program funds" (Petrei, 1998, p. 391). Much the same has happened in Asia and the Pacific. On the positive side, these experiences have contributed in some countries to improve the presentation of the budget. Also, it is possible that they may have led to a somewhat greater performance orientation by budget officials although, as noted, there is a variety of less costly ways to introduce greater focus in performance.

Box 11
Program Project Activity in the Philippines: An Example of Budget Presentation

Department of Health

A. Programs

I. General Administration and Support
II. Support to Operations
- a. Health information and health education services
- b. Health human resource development program
- c. Health policy and development program
- d. Department legislative liaison office
- e. Executive liaison and coordination
- f. International health relation
- g. National drug policy
- h. Essential national health research
- i. Support to regional health training centers
- j. Local government assistance and monitoring service

III. Operations
- a. Public health services
- b. Public health care program
- c. Health facilities and operations
- d. Standards, regulations, licensing and regulations, and other health facilities
- e. Provision of drugs and medicines, medical and dental supplies and materials, vaccines, reagents, and other biological supplies

B. Projects
I. Locally-Funded Projects
- a. Provision for construction, improvement, repair and rehabilitation/renovation and purchase of equipment of special hospitals, medical centers, sanitaria, regional hospitals, central office and regional field health offices and financial assistance to other health facilities on a priority basis.
- b. Acquisition of ambulance and other health related equipment
- c. Aid to Dr. Jose Rizal Memorial Foundation Hospital in Dasmariñas, Cavite

II. Foreign-Assisted Projects
- a. First Water Supply, Sewerage and Sanitation Sector Project (IBRD Loan No. 3242 PH)
- b. Philippine Health Development Project (IBRD Loan No. 3099 PH)
- c. Palawan Integrated Area Development Project (ADB Loan No. 1033/1034 PHI)
- d. Urban Health and Nutrition Project (IDA Loan No. 2506 PH)

Source: General Appropriations Act, Philippines, 1998.

5. Other performance-oriented approaches

a. Increased flexibility

Some countries (e.g., Australia, Sweden, Singapore) have recently introduced "block" appropriations which involve allocating a lump sum to line ministries or agencies, which are then free to determine the best mix of economic inputs to produce their services. Canada's Envelope Budgeting System of the 1980s was in many ways a precursor of these block budgets.

While increased flexibility in budgeting is desirable in principle, without a hard financial constraint it is likely to lead to the "needs" mentality which is antithetical to good PEM (see chapter 4). Given a hard financial constraint, the appropriate degree of flexibility depends on the country's context, especially the soundness of governance system and the accountability regime. Thus, for example, eliminating the separation between wage and non wage expenditure could have undesirable outcomes in many developing countries and transition economies, by leading to even greater overstaffing than is the case, even lower maintenance expenditure, and opening up new possibilities for corruption. Weak compliance may require accurate monitoring of budget execution of specific particular items (see chapter 6).

A number of developed countries have reduced the number of appropriations in their budget in to increase flexibility in project and management. This is desirable in a number of developing countries that define an appropriation for each subordinate spending unit within a ministry or a department, or for each project. However, the policy objectives should be clearly presented to the legislature and should not be altered during budget execution (e.g., it would be questionable to mix primary education and higher education into one appropriation or to allow unrestricted resource transfers between these two subsectors). But certainly, esxcessive detail in line-item classification and rigidity of rules lead to inefficiency and disempowerment without any corresponding advantage.

Some developed and developing countries have adopted a progressive approach to granting flexibility to line managers, linking it to some agreement on goals and performance. This approach is notably developed in Malaysia (see box 12). It could fit the situation of several developing countries or transition economies which do need to make their budget systems more flexible and efficient, while avoiding the risk of overruns in public spending, weaker expenditure control, or wider corruption.

Box 14
The Modified Budget System In Malaysia

The Modified Budgeting System (MBS) was first introduced in 1990. Under this system, the Controlling Officer is responsible for determining the performance of his department in terms of output and impact, which are recorded in the program agreement for his department. The program agreement is a document that records inputs, outputs and impact of an activity as agreed upon between the Federal Treasury and the department during budget execution.

To enable Controlling Officers to manage their resources more effectively, a generalized approach to expenditure control would be used. Controlling Officers are given greater powers in the utilization of the organizations resources. For example, they can transfer resources across activities within a particular program without prior approval from the Treasury. Input monitoring, however, is not abandoned.

Source: Tan Sri Dato' Seri Ahmad Sarji bin Abdul Hamid, Chief Secretary of the Government of Malaysia, “Improvements in the Public Service for the year 1992,” 1993.

b. Instruments for measuring and improving performance[11]

As explained in more detail in chapter 15, several countries have developed performance measurement systems. An emphasis is put on the "3Es", that is, Economy, Efficiency, and Effectiveness. Economy is “the acquisition of the appropriate quality and quantity of financial, human and physical resources at appropriate times and at the lowest cost concerned,”[12] and may be assessed through input measures and comparisons with norms and standards. Efficiency is the relationship between outputs and the resources used to produce them, and is measured by cost per unit of output. Effectiveness is the extent to which programs achieve their expected objectives, or outcomes. *As a general rule, performance should be measured by that **mix** of input, output, outcome that is appropriate to the specific sector in the country concerned during the relevant period*.

From the budgetary point of view, developing greater performance orientation calls for giving more responsibility to managers; developing realistic indicators; and cost measurements; implementing accrual accounting in the agencies that deliver services; and structuring the ministries' budget to set up performance indicators at the appropriate level (the activity or an agency sub program). However, performance orientation does not necessarily call for major changes in the budget system. Inputs are still important as a budgetary guideline; the link between performance and the budget is indirect and often inferential rather then direct and automatic; and budgetary pressure moves the use of performance indicators more to the ex-post evaluation.[13] This assessment, drawn from the experience of developed countries, is even more applicable to developing countries, with their weaker governance system and administrative capacity limitation. Indeed, the confusion between performance orientation as the goal and performance budgeting as *one* means of fostering such orientation, has led to the costly introduction of program budgeting (or output budgeting) without any positive impact on performance orientation itself. In most developing countries, regardless of the budgeting innovations introduced, some form of line-item budgeting should be kept as an essential safeguard of the public resources.

c. The “agency model” and the accountability framework

Following the approach developed by the United Kingdom under its Next Steps program, some countries are developing an organizational model that separates the delivery of services and administrative tasks from policy formulation. By drawing a boundary around operational functions (such as payment of pension checks) and giving the task to a separate entity, the responsibilities and expected performance can be clearly specified and staff and managers can be made accountable for performance.[14]

In theory, this approach could improve efficiency in service delivery. However, caution is required before considering its implementation, especially in developing countries or transition economies. The “separate entity” can easily in practice deteriorate into extra-budgetary fund and disappearing budgets (see chapter 2 B.1). It is also questionable whether organizational reform is really needed to clarify mandates (e.g., compared with appropriate delegations of authority). Finally, there are risks for both sound policy-making and effective implementation in an excessively rigid boundary between the two, with policy formulation increasingly isolated from realities of delivery of programs and services.[15] No general statement can be made on these issues other than to emphasize the grave risk of importing these practices without careful consideration. Their applicability depends on experience, culture, and administrative capacity each country.

Several OECD countries have extended their accountability framework. The traditional accountability for financial compliance is maintained, but has been extended to accountability for efficiency and economy in operations and to some accountability for outcomes. Line ministers and/or agencies are accountable for their performance, assets and liabilities. Full financial disclosure is required from them. Each agency is viewed as a separate entity with its own accounts, and must produce annual financial statements that disclose its financial performance, assets, and liabilities.

d. Output budgeting

Output budgeting, which has been adopted in New Zealand, and, to some extent, in some Pacific Island countries, represents the culmination of the performance budgeting approach and, as such, carries all its advantages and risks. The data requirements, methodological difficulties, and demands on implementation capacity are vast. Output budgeting is based on the “principal-agent” paradigm, whereby the ministers are seen as principals and the executive agencies as their agents. "For example, the Police Commissioner contracts with the Minister of Police to provide a certain level of policing services, patrols, community security programs, road safety commercials, etc. The commissioner does not contract to lower the crime rate.[16] The crime rate is affected by many variables beyond the control of the Commissioner."

In New Zealand, a single agency may have as many as 150 outputs (e.g. for the Treasury).[17] Budgetary appropriations are defined by classes of output. Output classes are category of conveniences and are defined by the act as any grouping of similar outputs.[18] They are more or less similar to what is called in other countries, a subprogram or activity. Appropriation management rules (transfers between classes, budget execution controls by the Auditor-General) are established at this level.

The number of appropriations is relatively high. There are about 500 to 700 appropriations (classes of output) in the budget.[19] "One factor that explains the number of output classes is the effort to ensure that funds are spent on particular activities (such as managing contracts) and are not pooled with other administrative expenses."[20]

The costs of outputs are determined on the basis of the costs of inputs. This mode of calculation and the number of output classes have not yet allowed the budgeting processes to be fully output-oriented.[21] However, it is expected that some outputs will be classified into a class C where their costs would be based on output prices instead of input prices (e.g., benchmark prices).

As noted, the data, administrative, and transaction requirements of implementing an output-budgeting system are heavy, and include an accrual budgeting system cost measurements, contract negotiations between ministers and managers, and intensive monitoring of results, including the elusive factor of output quality. The benefits could be substantial in theory, but there is little evidence of a positive across-the-board impact of the approach, even in New Zealand.[22]

The Ministry of Finance officials in most developed countries have considered output budgeting and concluded against recommending it. As for developing countries, the international consensus is that the approach is wholly unsuitable, although a few exceptions are conceivable.

B. EXPENDITURE CLASSIFICATION

1. The importance of a good classification system

Classifying expenditures is important in policy formulation and the identification of resources allocation among sectors, the identification of activities of the government and the level at which performance should be assessed (if a performance-oriented approach is developed; see chapter 14); the establishment of accountability for compliance with the Parliament’s authorizations, policies, and performance; analysis; and day-to-day budget administration. An expenditure classification system provides a normative framework for both policy decision making and accountability. The best-known classification systems are the functional "Classification of the Functions of the Government (COFOG)," developed by the United Nations, and the Government Financial Statistics (GFS) classification, developed by the IMF. Other classifications, however, can also be useful, as discussed below.

Expenditures must be classified for different purposes, such as: the preparation of reports that fit the needs of report users (policy decision makers, the public, the budget manager); the administration of the budget and budgetary accounting; and the presentation of the budget to Parliament.

Paradigms in public expenditure management often govern the organization of the expenditure classification system, but paradigms change from time to time. To respond to different demands and needs the solution is not to find the budget classification that fits a paradigm, but to identify elementary classifications that are needed. Undoubtedly, the function of these elementary classifications in the budget process will depend on the approach to public expenditure management, but the first step is to establish them in a coherent manner.

Expenditures should also be reported along the international standard classification, defined in GFS. However, it should be noted that the GFS manual provides guidelines on classification for reporting purposes only. They are not intended as budget or account classifications. Moreover, GFS focuses only on economic and functional reporting, while a budget classification needs to be an instrument for policy formulation, budget administration and accounting.[23]

According to the different needs for policy formulation, reporting and budget management expenditures must be classified according to the following categories:

- *function*, for historical analysis and policy formulation (e.g., COFOG);
- *organization,* for accountability and budget ration;
- *fund* (source of financing, EBF-special accounts, if any)
- any other category needed for budget ration or to take into account special requirements;

- *economic* category, for statistics (GFS) and *object* (i.e., line item), for compliance controls and economic analysis;
- *program* and activity and output, for policy formulation and performance accountability (depending on the definition of these categories and on the approach to public expenditure management).

This section concerns only issues related to the classification of expenditures. Issues related to the organization of budgetary accounting are reviewed in chapter 5 and issues related to government overall accounting are reviewed in chapter 10.

2. The U.N. Classification of the Functions of Government (COFOG)

A functional classification organizes government activities according to their purposes (e.g., education, social security, housing, etc.). It is independent of the government organizational structure. A functional classification is important in analyzing the allocation of resources among sectors. A stable functional classification is required to produce historical surveys of government spending and to compare data from different fiscal years.

The Classification of the Functions of Government (COFOG) established by the United Nations is presented in the SNA and GFS manuals. The objective of COFOG is to give a standard classification for international comparisons. It is consists of into 14 major groups, 61 groups and 127 sub groups.[24] The COFOG, or at least its 14 major groups, is widely implemented in developing countries. Oftentimes, however, industrialized countries have their own functional classification, which may be either limited to about 10 to 15 functions, or much more detailed.

For developing countries that do not yet have their own functional classification, adopting COFOG instead of a customized classification presents significant advantages. It is already established and well-documented in the GFS manual. It facilitates international comparisons.

A country may desire to reorganize the COFOG classification, as it is considered in GFS.[25] In this case, a mapping table between COFOG and the country functional (and program) classification or between the country organizational classification and COFOG should be established to allow reporting when needed under COFOG.

Public reports showing expenditures along functional categories should be prepared. They do not need to be excessively detailed, but should show at least government expenditures along functions similar to the 14 major groups of COFOG, completed by the most important groups (box 13).

Box 13

FUNCTIONAL CLASSIFICATION: Grouping of COFOG Functions as shown in GFS

Code COFOGE	
	General public services and public Order
1	General public services
3	Police order and safety affairs
2	**Defense**
	Social Services
4	Education affairs and services
4.1	Preprimary and primary education
4.2	Secondary education
4.3	Tertiary
4.4-6	Other
5	Health affairs and services
5.1	Hospitals
5.2	Clinics, practitioners
5.3-6	Other
6	Social security and welfare
7	Housing, water supply. Sanitation
8	Culture and Recreational affairs
	Economic Services
9	Fuel and energy affairs
10	Agriculture, forestry, fishing and hunting
11	Mining-Manufacturing-Construction
12	Transportation and communication
12.1	Roads
12.2-6 & 8	Other transport
12.7	Communications
13	Other economic affairs and services
14	**Expenditures not classified by major group**
NC	Interests
NC	Intergovernmental transfers

3. GFS Economic classification

An economic classification of expenditures is required for budget analysis. Issues such as, the share of wages in government expenditures, and the weight of transfers to public enterprise, for example are crucial. At the very least, the economic classification must be fully consistent with the GFS economic classification of government expenditures. The object/line-item classification is more or less an economic classification, but, in many countries should be, revised or reorganized to be compatible with the GFS economic classification.

Reports based on GFS generally use net concepts, for “lending minus repayments,” “financing,” and “net surplus or deficit of departmental enterprises,” although the memorandum items of GFS include the gross flows. It must be stressed that these net items can be sufficient for macroeconomic analysis, but not for budget formulation and management. In the accountants' books, gross flows must be recorded. From the policy formulation point of view, the item “lending minus repayments” should be to separate loans, repayments, acquisition and sale of equity or assets detailed broken down (assets acquired for policy purposes are consolidated with lending in GFS)[26].

The SNA classification is different from the GFS. Full reporting along the SNA in preparing the national accounts is desirable. However, this issue is related to the implementation of an accounting system covering, besides the budgetary operations, the assets and the liabilities of the government (see chapter 10). GFS is moving to an accrual basis for reporting government expenditures and liabilities, in the interest of creating greater statistical comparability between fiscal and national accounts.[27]

Box 14
GFS Economic Classification

Expenditures for goods and services
- Wages and salaries
- Employer contributions (pensions—social contributions)
- Other goods and services

Subsidies
Current transfers
Interest
- Domestic

External
Capital expenditures
- Capital expenditures
- Capital transfers

Lending minus repayment (1)
- Loans
- Repayment of loans
- Sales of assets
- Other

(1) Not presented in the 1986 version of GFS. Source: IMF.

4. Object (line-item) and input classification

For budget management purposes, the traditional budgets include an object classification (also called "line-item classification").[28] This object classification groups purchases along categories used for budgetary control and monitoring, such as different categories of personnel expenditures, travel expenses, printing. For goods and services, the object classification is an input classification.

a. Relationship with an economic classification

As indicated above, the object (line-item) classification needs to be compatible with the GFS economic classification (with details for the item "lending minus repayment"). Often, for goods and services, this requires only to grouping the objects into sets of objects that fit the GFS classification. This can be done by reorganizing the object classification to make the objects a subcategory of GFS economic categories, or any other method of grouping. For transfers and other items, it may be necessary to provide break down of objects into homogenous categories that fit the GFS classification, but this concerns only few budget items, compared with goods and services.

The economic classification of development expenditures, which in several developing countries is distinct from the object classification, must also fit the GFS standard. In some countries, all development expenditures are classified as capital expenditures, although the development budget includes goods and services expenditures, while the recurrent budget includes capital expenditures.

A unified economic classification covering both the recurrent and the development budgets is needed. Subcategories of this classification can be specific to either the recurrent or the development budget, for example, transport of things in the recurrent budget and consulting services in the development budget. Nevertheless, both budget must share at least a basic economic classification that fits GFS.

Capital expenditures should be defined strictly according to the SNA standard. The SNA definition of capital expenditures does not correspond necessarily to the countrys common definition of capital expenditures. This requires to defining a subcategory that fits the SNA definition within the country's category, capital expenditures.[29]

b. Management and control implications

The object classification is or was often associated with ex-ante detailed controls. A budget formulation focusing mainly on inputs and rigid appropriation management rules (i.e., rules for transfers between line items) leads to poor budgeting. In several countries, this requires revising appropriation management rules and often to rationalizing object classification. Budget execution control processes are discussed in chapter 6.

However, issues related to controls or line-item budgeting should not lead to abandoning input classification, which is required in any management system. For internal management, close monitoring of inputs is required. The Ministry of Finance does not need to review the allocation of resources between expenditures for paper and other supplies, but the managers of the spending units may need to do so.

Some expenditure items for which there are risks of arrears generation (such as utilities' services consumption) must be monitored centrally in many countries. Moreover, in some countries, rules for either protecting some items (such as electricity consumption) or on the on the other hand capping other categories of expenditures (e.g. mission of ministers abroad) are desirable. However, these rules should focus on what it is necessary and are not supposed to be permanent. What can be a problem for compliance one year will not necessarily be a problem the following year.

Regarding aspects related to control, some line-item classifications are both too detailed and yet not adequately specified. The solution is not to increase the number of items, but to incorporate a special item temporarily into the classification whenever so required.

c. Input classification for “expenses”

The traditional object classification as well as the GFS economic classification concerns expenditures. Under an accrual accounting system, expenses instead of expenditures are posted, The economic classification must be complemented by categories proper to expenses (e.g., depreciation of physical assets, superannuation liabilities)[30].

5. Administrative classification

An administrative classification of expenditure (by governmental organization) is needed for clear identification of responsibilities in public expenditure management and also for day-to-day administration of the budget. Expenditures must be divided into separate sections for each ministry, department, or agency. The administrative classification of expenditures obviously needs to be tailored to the organizational arrangements for public expenditure management (e.g. the hierarchical levels within a line ministry that deal directly with the "Treasury"). The administrative classification should be organized along the different levels of responsibility and accountability in budget management (e.g., the entity that is accountable to Parliament, the administrative levels that deal with the Ministry of Finance for budget preparation).

In some countries, expenditures are presented by organization but not always at the same level of aggregation heterogeneous manner. For example, personnel expenditures are presented by ministry, while other current expenditures are presented by lower level government entities. This could be suitable for administration and controls, hampers the assessment of the running costs of the different department and agencies.

6. Program classifications

As discussed earlier, a program is a set of activities that meet the same set of objectives. Compared with COFOG functions, a classification by program takes into account the country policy objectives or administrative context.

In some developing countries, a classification of expenditures by program has been set up, often as part of attempts to implement a PPB system. To establish these programs, an exercise to establish the chain objective-program has sometimes been carried out. However, programs are often barely a nickname for an organization, or a sub-function of the COFOG, or only a grouping of individual investment projects, while the recurrent budget is presented in the traditional manner. Programs may located within a line ministry or be a cross ministries.

The major problem when preparing a program classification is avoiding both an overambitious approach that can not be implemented and an approach that would be limited to adding useless category to the existing classification system. A classification by program can be recommended for different purposes, from developing a performance-oriented budgeting approach to increasing the readability of the budget In the latter case, the COFOG classification can be program classification, provided that it is supplemented with other classifications dealing with special policy issues relevant to the country's policy context (e.g., an environmental program, a nuclear program).

The issue of reconciling of the program classification with the organizational structure of the government is one of the points that generated debates on the pros and cons of program budgeting and explains its failure. Actually, to set up performance indicators, accountability requirements suggest that the organization of programs and activities should fit the governmental structure. Programs should be defined by line ministries and could in a majority of cases, correspond to a major subdivision of this line ministry. Activities or subprograms should be defined in the most convenient manner to establish performance indicators (see chapter [performance]). The classification of expenditure by activity cannot be established from the top and must be prepared by relevant line ministries and agencies and then discussed with the Ministry of Finance.

Interministerial programs can be established for special cross-cutting issues. However, it is certainly not necessary to reorganize the whole budget classification system to take into account a limited number of interministerial programs. A table annexed to the budget showing which activities are covered by these intersectoral programs is sufficient for decision-making and for follow-up the program implementation.

7. Expenditure classification in an output budgeting system

Output budgeting requires distinguishing appropriations related to outputs from other appropriations. Thus, the New Zealand budget distinguishes the following seven classes of appropriation.[31] "(i) output classes, e.g., policy advice, management of contracts, policing, custodial services, etc.; (ii) benefits, e.g., unemployment, domestic purposes, scholarships; (iii) borrowing expenses, e.g., interest expenses, premiums, borrowing, other finance costs; (iv) other expenses, e.g., restructuring costs, litigation costs, loss on sale of fixed assets, overseas development aid; (v) capital contributions, increase in investment in a department or an SOE to increase its output capacity or improve its efficiency; (vi) purchase and development e.g. state highways, national parks, Parliament Buildings of capital assets and; (vi) repayment of debt e.g., foreign currency debt repayment. Benefits and capital contributions are appropriated on a cash basis, borrowing expenses on an accrual basis, but this is also done in a majority of countries with a cash budget system. Outputs are appropriated on an accrual basis.

8. Other special classifications

In developing countries, expenditures must be classified by source of financing (domestic resources—consolidated fund and counterpart funds—loans, grants).[32] EBFs or Treasury special accounts if any, need to be identified.

Other special classifications may be needed for managing the budget. For example, Parliaments often request a presentation of expenditures by region. This issue depends on the country context, but must be kept in mind when reviewing a budget classification system. An information system for budget management must be able to integrate classification requirements that were not expected when it was designed.

9. Implementation issues

a. Expenditure classification and budget management

From the budget management point of view, the most important issues related to expenditure classification are the following:

- *For tracking uses of appropriations ("budgetary accounting"),* organizing the books, coding the transactions, etc., it is necessary to define an expenditure classification that includes at least the administrative classification (possibly completed with a subdivision of spending unit by activity), funding (financing source, EBF, if any, etc.), and the economic-object classification.

- *For presenting the budget to the legislature*, it is necessary to define the appropriation, i.e., what is binding for the executive (e.g., the budget of a ministry, a program within a ministry, each individual object).

- *For managing the budget*, it is necessary to determine at which level rules for transfers between budget items ("virements"), controls, etc., are established (i.e. at line-item level, at economic category, at the level of programs, etc.). Sometimes, a "rationalization" of the object code has led to increased ex-ante controls or to their extension to the development budget, because additional line items have been introduced. A change in budget classification must include a review of appropriation management rules and of the impact of the change on the administration of the budget (appropriation management rules are discussed in chapter 5).

b. Administrative and institutional issues

Classifying expenditure requires first an identification of the technical and institutional constraints on reforming the system. Attention must be paid to the organization of the books and the information systems. For example, when interest is mixed with amortization, there is an obvious need to separate them, but even more important is the scrutiny of how the debt management office keeps its books. Also, badly designed or documented information systems can be an obstacle to reforming expenditure classification. Therefore, a review of current applications and software is generally required when reforming the expenditure classification system[33]. On the other hand, software and application developments should not only be compatible with the existing classification but also allow further changes in classification.

Reforming expenditure classification cannot solve deficiencies in reporting caused by institutional arrangements. A powerful extrabudgetary fund will not want to show its expenditures along *any* classification, whatever the classification system.[34] Compatibility with COFOG, GFS, or anything else will not resolve deliberate and systematic misreporting. Bad, or badly-presented, information is useless under any classification. Institutional issues must be addressed as such.

c. Reporting along COFOG and coding

Changes in the organization of the books should focus on what is required to identify transactions properly. Often, a reform of the budget classification system attempts to include into the hierarchical nomenclature or the codes used in the day-to-day administration, the codes of all categories needed for reporting (COFOG, program, etc). Consequently, the coding system used to register the transactions becomes cumbersome and difficult to manage; when budget execution is not fully computerized. This has contributed to halting or delay the reform of the expenditure classification system in several countries. Fortunately, these cumbersome nomenclatures can be avoided, as explained below.

For example, countries that have a detailed administrative classification do not need to change the format of the books or the coding of their forms to report under COFOG. They need only to classify spending units along COFOG. (A similar suggestion is made in the SNA and GFS manuals[35]). If a report on payments is available by division/project and if division/projects are classified along COFOG, it is possible to present the payments along COFOG simply by linking the report on payments and the table that classifies organizations along COFOG categories. This can be done easily with a personal computer and a spreadsheet. In a few special cases, where several functions are assigned to a spending unit, it is necessary to classify the activities of the relevant organizations along COFOG, but this does not require a major change in the classification structure.

A similar approach can be adopted for programs. Figure 3 shows the different expenditure classification subsystems needed for reporting and budget management, and the relationships among them. Crosswalks between the activity category and the object and other categories needed for administration give the lowest common denominator of the expenditure classification subsystems.[36] The coding system used in the day-to-day administration of the budget must identify this lowest common denominator, but does not need to describe all its attributes. The activity can be attached to organizations, functions, and programs, but need not be attached to all these categories when coding the forms, vouchers, etc. A small addition to the administrative code is sufficient to identify the activity. Therefore, in the day-to-day administration of the budget, to present expenditures by program or along the COFOG classification it is sufficient to recorded for each transaction the administrative code, an activity code established by spending unit or project and, the object and financing source codes.

[Please see attached Figure 3]

In a number of countries, a hierarchical budgetary nomenclature (coding system) is used in the day-to-day administration of the budget. The nomenclature is organized as follows: line ministry →directorate→spending unit→object→ the budget code including the administrative and object codes. Hierarchical, or decimal, coding helps in classifying homogeneous categories and is useful within a manual management environment, but it should be simple, and redundancies should be avoided. Within a computerized environment, on the other hand, hierarchical nomenclature is not very useful. The first task of an informatics expert when setting up a budget data base will therefore be to detail the hierarchical nomenclature in order to set up tables and link them by relationships. Each table should correspond to only one category of the budget classification system, and codes should be defined table by table, category by category.

C. PRESENTATION OF THE BUDGET

1. Major requirements

The budget submitted to the legislature should include all elements needed to assess budgetary and fiscal policy and present the appropriations according to the needs for legislative control by the Parliament. Revenues, expenditures, and the fiscal outturn should be presented together.

Concerning the expenditure side, one may distinguish: (i) a “main” presentation, on the basis of which appropriations are voted; and (ii) annexes that give additional information.

2. “Main” presentation of the budget

The main presentation of the budget includes estimates that show appropriations. In some countries, authorizations are granted through an “appropriation act, while in other countries, the appropriation is defined as a level of the expenditure classification system.

In the budget, the appropriations may or may not include sub-items for information only. Some countries present thousands of line items in the budget while others have very few. Thousands of line-items make the budget difficult to read and require summaries to make the presentation readable. The optimal number depends on country-specific factors, primarily on the rules governing transfers among these appropriations, and on the organization of the government.

Some countries limit, the number of appropriations to 20 or even less. However, most of these countries also have a detailed annual expenditure plan by organization, program, and economic category, which is either internal to the executive (as in China and Vietnam) or presented through various annexes to the budget. Two distinct situations may be found:

- In some countries, the presentation of the budget to Parliament is a pure formality. Where the executive has all the power, many of the issues discussed in this manual are not relevant, notably, the nature of appropriations, the comparison of cash controls with accrual-based controls, accountability rules, financial reporting, etc.

- In other countries (e.g. some FSU countries, before the current reforms), elements of the annual expenditure plan are discussed in Parliament committees. Line ministries go to the committees to negotiate items in expenditure plan prepared by the Ministry of Finance. The Parliament thus

> plays an important role in budgetary bargaining. However, the lack of a comprehensive, formal, and public budget impedes sound decision making.

The main presentation of the budget should clearly identify responsibilities in budget management. The appropriations should be presented by line ministry and independent agency, and by their major subdivisions. In several FSU countries, the budget is or was presented by program instead by line ministry or agency. Reforms are currently under way to remedy this problem (e.g., Ukraine for instance, reformed its budget classification system in 1997).

In several developing countries, the recurrent budget is presented by line ministry but the development budget is presented by broad function, program, and project. This fits a planning implementing the development programs must be shown. Moreover, presenting development expenditures and recurrent expenditures together under the same administrative headings (but under separate appropriations) is required for an assessment of the overall budget of a line ministry or an independent agency. Therefore, within the main presentation of the budget, development projects should be seen as an administrative category, and classified by line ministry or independent agency.

3. The need for separate presentation of current and capital budgets

Administrative considerations are generally more influential than economic or policy considerations on the decision of whether a given expenditure is included in the current or the "development" budget. Procedures for administering the recurrent budget are generally not suitable to the management of some categories of expenditure, particularly expenditures by external sources and construction projects. Generally, regulations to implement the "development" budget are much more flexible than those for the recurrent budget.

Projects financed by donors are often of composite nature, and may include both current and capital expenditures, particularly in the social sectors. They have nevertheless a single project manager and are often submitted to special reporting requirements from donors. Thus, although the distinction between "recurrent" and "development" expenditures is artificial and questionable, for accountability and management purposes aid-dependent countries are obliged to follow it in the presentation of the budget. This state of affairs would change only if donor requirements and the basic modalities of project-centered assistance are fundamentally changed, which could present vast advantages in terms of the development impact of the assistance and the functioning of the PEM system in developing countries.[37]

Thus, for management purpose, in most aid-dependent countries "development" projects must be separated from other expenditures. However, presenting together development expenditures together with recurrent expenditures under the same administrative headings (but under separate appropriations) is required in order to assess the overall budget of a line ministry or an independent agency. In countries with dual budgeting, such unified presentation will not eliminate all the negative effects of dual budgeting processes discussed in chapter 4, but will facilitate scrutiny of sector budgets.

Within the "main" presentation of the budget, development projects should be seen as an administrative category, and classified according to line ministries or agencies. Therefore, in aid-dependent countries or in countries that have a dual budgeting system, the presentation could differ from the one mentioned earlier, as follows:

- Ministry (or agency)
  - Directorate (or other major administrative subdivision)
    - Program (if any)
      - Current expenditures
      - Capital expenditures (items not included in the "development" expenditures
      - "Development" expenditures (domestic/external resources)
        - capital
        - current
    - memo: total current
      - total current expenditures
      - total capital expenditures

The approach adopted in transition economies is generally more “economic” that the “management approach” mentioned above. In these countries, the traditional “State Annual Investment Program” has a narrower coverage than the “development” budget of developing countries, and covers often only net investment, i.e. the creation of new capacities. Investments financed under the “State Annual Program” are (or were) included in the items “capital expenditures” of the budget together with other capital expenditures. Therefore, it is often difficult to compare the investment program with the budget. Where there is an investment program distinct from the budget, it is necessary to adopt a presentation of expenditures in the budget that allows the budget and the investment program to be compared.

Box 15
Development Expenditure: Appearance and Reality in South Asia

In most South Asian countries, separate authorization is given for a “development” budget. However, the differentiation between the current and capital components of this budget is formal and highly technical. Since legislators are rarely well-educated in the finer technicalities of budgeting (and are not supposed to be), and parliamentary staffs are not strong, it is very difficult for the legislature to discern the true amounts of capital expenditure and hence the breakdown between current and capital expenditure in the overall budget they are asked to approve.

A reclassification within the budget of Bangladesh and Nepal shows that in both countries, true government capital expenditure is systematically and substantially lower than the amounts in the development budget In Bangladesh, for instance, out of the total public expenditure under the annual development budget of Tk 37.4 billion in 1987-88, as much as Tk 10.4 billion or 27.7 percent can be classified as non-investment expenditure, compared to the 16.4 percent of total public expenditure shown in the current budget.

Not only is capital expenditure overestimated at any given point in time, but the trends are obscured as well. Thus, development expenditure in real terms in Bangladesh declined at an annual average rate of one percent during 1982-87. However, true capital expenditure during this period actually contracted at a much higher average annual rate of 2.3 percent. The mirror image of this distortion is that current expenditure is typically underestimated. For example, in the late 1980s reported growth in Bangladeshi current expenditure was 4 percent, compared with the 5.2 percent shown by the economic classification of the budget.

Source: Adapted from *The Control and Management of Government Expenditure: Issues and Experience in Asian Countries*, ESCAP-UNDP Development Papers No. 13, 1993.

3. Presentation of capital expenditures

A unified presentation of the budget should not lead to neglecting the need for a clear distinction between capital and current expenditures. This issue should not be confused with the debate on dual presentation of the budget or, even less so, with dual budgeting.

Some of the reasons given for keeping capital and current budgets distinct are questionable. Capital expenditures are not unique in contributing to future production. What is important for development is not only the volume of investment, but the efficiency of investment, as well as an adequate mix of both capital and current expenditures (e.g., teacher wages can affect the quality of education and future growth more than the number of new schools). Also, the static and mechanistic view of the relationship between investment and growth (usually identified with the Harrod-Domar model), has been shown long ago to be simplistic and often very misleading, especially because it focuses attention away from the issue of efficiency of investment and from implementation capacity problems. Furthermore, government borrowing policy should not be related only to the desired capital stock. An enterprise does prepare its borrowing plans according to profits expected from investments. But the government has to take into account the macroeconomic effects of policy. Both current and capital expenditures affect aggregate demand; and borrowing policy must be established by reference to macroeconomic and fiscal targets in their entirety, and not only to investment.

Nevertheless, a clear distinction between current and capital expenditures is necessary, for analytical purposes, transparency, and policy decision-making. In the first place, the distinction is needed for an assessment of the operating costs of government and the efficiency of government activities. Moreover, investment expenditure generates a stream of future costs and benefits and is analytically and financially different from expenditure whose effects are extinguished within a short period. Finally, developing a performance-oriented approach requires a separation between running costs and capital expenditures. Indeed, some developed countries (e.g., the U.S.) that have not traditionally made a clear separation between capital and current expenditure in the presentation of the budget are now considering the possibility of creating a separate capital account:

> *Although reducing the federal deficit and making wise decisions on investments that will foster economic growth are the most important contributions that the federal government can make to a healthy and*

growing economy, the current budget structure, with its focus on short-term goals, does not meet these needs. If long-term economic growth is to be increased, the budget needs to focus on long-term decision-making. A federal investment budget component could help Congress and the President make better-informed decisions on federal spending on consumption versus investments for the future. GAO, recognizing the importance of the deficit to long-term growth, urges that such a component be established within the context of a unified budget framework striving to cut the deficit over an appropriate period. Setting investment targets in the congressional budget resolution could be a useful and feasible way to implement this concept.[38]

4. Budget annexes and other documents

Annexes to the budget presented to Parliament are needed to give other presentations of appropriations needed to analyze the budget. For example, the following could be attached to the budget: (I) an annex by function; (ii) an annex by program, especially if there are multisectoral programs; (iv) if the main presentation, shows the breakdown between current and capital expenditures, an annex by development project/program (development budget); (v) if the main presentation already includes the “development” budget, an annex to show the true investment component; etc.

Appropriations should be compared with the appropriations of the previous year. An annex by function should show the growth of expenditures over several years (on the basis of actual budget execution).

Other documents can include: (i) narrative statements on each sector budget policy, presented by programs; (ii) performance indicators (see chapter 15); (iii) the presentation of the forward costs of multiyear projects; and (iv) if appropriate, multi-year estimates or a Public Investment Program (PIP) (see Chapter 12).

G. KEY POINTS AND DIRECTIONS IN REFORMS

1. Main issues

a. Nature of the budget

In a cash-based budget, most appropriations define a limit for cash payment and annual commitments. A cash-based budget fits well the needs for expenditure control and budget administration. It does not impede the development a performance-oriented approach to budgeting (see chapter 15) and an accrual or modified accrual accounting system (see chapter 10). It needs, however, to be supplemented by instruments for assessing and controlling forward commitments and the fiscal impact of policy decisions.

Few countries have recently developed accrual-based budgets, where appropriations for operation cover full costs (including depreciation). An accrual-based budget can provide spending agencies with a framework for improving performance. However, its implementation requirements are heavy and it requires additional mechanisms for controlling cash. Abandoning cash-commitment-based appropriations in developing countries and transition economies is not recommended.

b. Budget systems

The traditional approach of line item budgeting fits the need for expenditure control. However, when associated with an input-oriented approach in budget formulation and detailed expenditure controls, it impedes both performance and program prioritization.

To improve policy formulation, public expenditure management and performance it is necessary to focus more on result and policy objective when formulating the budget, to give needed flexibility in management to spending agencies, and to develop instruments for measuring performance (see chapters 5 and 15).

In developing such approaches countries should be aware of the risks of making over ambitious reforms that will prove to be ineffective and of disrupting the classic rules for compliance.

c. Expenditure classification

An expenditure classification system is an instrument for policy formulation, budget analysis, accountability, and day-to-day administration of the budget. All government expenditures should be classified along the same standards.

The classification system should include: (i) a functional classification for policy analysis, and statistics and international comparisons; (ii) an economic classification and object classification for economic analysis, and eventually, management control; (iii) an administrative classification for accountability and budget administration; (iv) any other classification needed for budget administration (e.g., fund classification); (v) eventually, a program and activity classification for policy analysis and performance review.

The expenditure classification must allow reporting along international standards (GFS). However, GFS, which focuses on economic and functional reporting should not be confused with an expenditure classification system for managing the budget.

A classification by program and activity can be an instrument for policy analysis and assessing performance, but should follow the lines of responsibility, to establish accountability.

Appropriation management rules associated with the expenditure classification system should fit needs for expenditure control and give sufficient flexibility in management (see chapter 7).

The budget presented to the legislature must clearly show responsibilities in program management and policy choices among programs and/or sectors.

[1]Such as for the Great Plains Conservation Program in the U.S. mentioned by Allen Schick in the federal budget".

[2] An accrual-based appropriation includes depreciation and is therefore different from an authorization to commit and an authorization to make a payment.

[3] In New Zealand, there are two ex-ante controls of cash payments made by the center (the Crown) to departments they are initially authorized by a warrant issued by the Governor-General, countersigned by the Audit Office; the Audit Office; the Audit office checks off on all the amounts to be paid from the Crown bank account on a daily basis to ensure that there is legal authority for such payments.

[4]In New Zealand, appropriations for the investment of departments are cash-based. In Netherlands, granting of funds to departments for investem through a loan/saving mechanism not through a cash appropriation as in New Zealand, see Harman Korte in OECD, *Accrual accounting in the Netherlands and the United Kingdom*, 1997.

[5] Except in theory, if the country is rescheduling debt. According to the definition given above, an accrual-based appropriation should include the interest to be paid *plus* the interests rescheduled.

[6] An obligation budget would need to be complemented by an annual cash plan, as would an accrual-based budget.

[7] In the literature on budget reforms, program budgeting is either considered as a form of performance budgeting or treated as a distinctive approach. This section relies, among others, on Premchand, (1983); GAO Performance budgeting: Past initiatives offer insights for GPRA implementation", 1997; and Robert M. Lacey," Managing Public Expenditure", World Bank.

[8] Emphasized among others by Petrei, 1998, p. 365 ff.

[9] In Malaysia, programs were made coterminous with the responsibilities of one ministry, after earlier unsuccessful attempts to reorganize government function/activity; in the beginning of the 1990s, Malaysia moved to a new system named the “Modified Budget System”.

[10] The U.S. Department of Defense still uses PPBS methodology. The extent to which this is a useful exercise is still being debated.

[9] The United Nations called Manual for Program and Performance Budgeting (1965) contributed to disseminating program budgeting in developing countries. As noted, the actual experience was disappointing and often counter-productive.

[11] See OECD, Performance management in government: Performance measurement and result-oriented management", 1994; OECD,"In Search of Results: Performance Management Practices," OECD, 1998.

[12] “Value for Money Auditing”, The Canadian Institute of Chartered Accountants, 1995.

[13] "In search of results, Performance management practices", OECD.

[14] Drawn up from Codd, 1996.

[15] Ibid.

[16] Malcolm Bale-Tony Dale, Public sector reform in New Zealand and its relevance to developing countries."

[17] Scott, 1996.

[18] Allen Schick, page 75.

[19] Ibid.

[20] Ibid. page 76. It should be noted that output-based appropriations are only one of the seven appropriation types in New Zealand.

[21]More consideration is given to line items in preparing and reviewing budgets than is commonly thought to be the case. Certain outputs, such as policy advice are budgeted in input terms, and managers indicated in interviews that their departmental budgets often are examined by Treasury Vote analysts in these terms... Moving from input to output prices would require major improvements in cost accounting, allocation and analysis", Allen Schick, The spirit of reform: Managing the New Zealand state sector in a time of change,” State Services Commission, New Zealand, 1996.

[22]Two contrasting approaches are in evidence in the recent developed countries’ experience. "One is the managerial premise that those who are responsible for government programs and organizations should be sufficiently empowered to act so that they can be accountable for their performance; the other is the contractual theory that government should be organized to minimize opportunism and transaction costs in relationship between self-interest parties" (Schick, 1996). And an OECD study notes that some countries “seem to have confidence that 'letting managers manage' suffices; the United Kingdom and New Zealand have acted on the presumption that it is necessary to 'make managers manage," (OECD, 1997).

[23] See detailed explanations on the differences between budget/accounts classification and the GFS reporting classification in William Allan (IMF), “Budget Structure and the Changing Role of the Government” in *Budget reform in developing countries*, paper presented to a Seminar in New York, December 4-5 1997, United Nations,1998.

[24] The last version of the SNA shows only the 14 major groups.

[25] GFS, for instance, notes: "There is a great deal of latitude for decisions as to the functions to be isolated and the way in which they should be grouped. Decisions made are never final but need to be reviewed periodically whether changing public demand and government priorities should be reflected in a changed classification. For example, the present concern (in the early '80s) with energy supply and conservation was the main motivation for creating a major group for fuel and energy. On the other hand, the classification does not yet contain a category relating to the protection of the environment since at the present time it does not seem possible to define and measure such a group."

[26] see William Allan, op.cit.

[27] IMF, *Government finance statistics manual: Annotated outline*", 1996.

[28] The U.S. object classification, for instance, includes: full-time personnel; other than full-time personnel; other personnel compensation; civilian persons benefits; benefits for former personnel; travel and transportation of persons; transportation of goods; rental payment to government agencies; other rental; communications and utilities; printing and reproduction; consulting services; other services; supplies and materials; equipment; land and structure; grants and subsidies; insurance claims and indemnities; interest and dividends. Allen Schick, *The federal budget*, Brookings Institution, 1995.

[29] For example, in New Zealand, military investments are included in the assets, while in the SNA they are classified as consumption. However, New Zealand publishes an additional statement consistent with the SNA methodology.

[30] For example, in New Zealand, the main classification by input (excluding transfers and capital expenses) showed in the external reports consists of the following categories: (i) operating expenses; (ii) personnel expenses (excluding pension); (iii) pension expenses; (iv) movement in unfunded pension liabilites; (v) depreciation of physical assets; (vi) depreciation of state highways; (vii) rental and leasing costs; (viii) loss on sale of assets; (ix) finance costs; (x) net foreign-exchange gains on liabilities; (xi) net foreign-exchange losses on assets (see IFAC Definition and recognition of expenses and expenditures, 1997).

[31] "Putting it together", New Zealand Treasury, 1996.

[32] Obviously, this classification is de facto implemented in every developing country. However, in one country this has been forgotten when implementing an expenditure management information system, that was supposed to control vouchers. Therefore, vouchers for cash payments were controlled by the computer on the basis of appropriations including forecasts of external financing.

[33] In a one country, once the budgetary nomenclatures were designed, it appeared impossible to classify personnel expenditures by division and directorate. However, the reason was that the payroll information system was badly documented and written in COBOL. The real problem was the information system and not the budget classification itself.

[34] This is a common problem in FSU countries, where the expenditure classification system is not compatible with COFOG.

[35] "For most other outlays [other than transfers and lending minus repayment], it will generally not be possible to use transactions as units of classification. Instead, COFOG codes will have to be assigned to agencies, program units, bureaus and similar units within government departments, "GFS page 143. Also see SNA , page 420. The SNA suggests for particular cases "an approximate division of the units outlays".

[36] In a relatively aggregated classification system, this lowest common denominator would be at the project/division level.

[37] An argument in this direction has been made for at least thirty years by scholars and development practitioners. See, for example, Schiavo-Campo and Singer *(Perspectives of Economic Development, 1970)*.

[38] Investment Budgeting for the Federal Government Testimony, 11/09/93, GAO.