

WHY BUDGETS MATTER: THE NEW AGENDA OF PUBLIC EXPENDITURE MANAGEMENT

New Thinking on Budgets and Aid

Recent years have seen dramatic shifts, in theory and practice, both in the area of public sector management and reform, and in the area of development assistance. The ideas and practices of the 'New Public Management' have reshaped thinking about public policy and management both in developed and in developing countries. The restructuring of public services in order to enhance their efficiency, with the introduction of more competition and private market discipline into public administration, was meant to transform bureaucratic culture and promote more open, accountable and results- and citizen-oriented governments. New Zealand, the UK, Sweden and others led the way among developed countries. And many of these ideas, despite some voices of concern, were introduced in civil service reform initiatives in many developing countries. In the area of budgeting as well, the focus shifted from the 'due process approaches' of conventional budgeting to a wider agenda of 'Public Expenditure Management', which highlights the importance of the complex web of actors and institutions involved in the budget process, and of linking expenditure with measurable results in terms of outputs and outcomes (Box 1).

Development assistance has also seen major shifts in thinking and practice in the recent past. From the Jubilee campaign for debt cancellation and the HIPC initiative to the Comprehensive Development Framework and PRSPs, from harmonisation efforts among donors to the Monterrey pledges for increasing aid flows, there are many signs of a new approach to development assistance. This new approach is based on a number of principles of good behaviour on the part of donor agencies, which should form the base of future aid relationships. They include:

- **Country leadership and ownership:** Donor processes, procedures and eventually objectives should be

subordinated to those of the recipient country.

- **Capacity building for the long term:** Donors need to work in a way that builds the capacity of recipient governments in a sustainable manner, neither simply filling short-term gaps nor over-using limited existing capacity.
- **Harmonization and simplification:** Transactions costs facing government need to be reduced by limiting duplication, and coordinating and simplifying the demands made by donors.
- **Transparency and information sharing:** This implies the full disclosure by donors of their resource flows and practices, in formats that are compatible with government cycles and systems.
- **Predictability of resources and conditionality:** Without predictability of resources and the simplification of conditions, implementing policies and delivering services becomes extremely difficult.
- **Subsidiarity:** Decisions within and between donor organisations need to be delegated to the level that is best for aligning aid with country systems.

On the operational side, country-led strategies have been promoted for guiding poverty reduction efforts, behind which donors should align. Sector programmes and budget support are placing new emphasis on coordination, complementarity and integration with government systems and procedures. For this reason budgets, and public financial management systems in general, have received increasing attention. As public expenditure becomes the privileged means for delivering services and reducing poverty levels and an ever greater percentage of aid funds flows through national budgets, concerns about efficiency, transparency and accountability in the budget process are bound to grow. Medium Term Expenditure Frameworks, computerised financial management systems and results-oriented budgeting are among the innovations that donor agencies have tried to promote in developing countries to improve the performance of public expenditure management systems.

Box 1: Paradigm shift in budgeting

| Old Paradigm <i>'Conventional Budgeting'</i> | | New Paradigm <i>'Public Expenditure Management'</i> |
|---|---|--|
| Budget process | | Budget policies and institutions |
| Rules | | Incentives |
| Inputs | ⇒ | Outputs/outcomes |
| Compliance | | Performance |
| Centralised control | | Decentralised responsibility |
| Bureaucratic opaqueness | | Transparency and accountability |

The Meaning and Importance of Budgets

Throughout the world, the processes for determining how to raise, allocate and spend public resources constitute one of the foundations of government. The way public resources are used is a major determinant of the achievement of public policy objectives. The annual

ODI's Centre for Aid and Public Expenditure (CAPE) was established in 1999, and has carried out policy-focused research on aid instruments, budget processes and the reform of public expenditure systems. It is now embarking on a new research programme, responding to the fresh challenges that are emerging in the field of development cooperation and public financial management. See: www.odi.org.uk/pppg/cape/

This briefing paper summarises the arguments for focusing on budgets and budget processes, highlights some the main lessons from past CAPE research, and outlines the main areas where future research should concentrate in order to improve the linkages between aid, budgets and poverty reduction.

budget is a key policy document, setting out a government's intentions for raising revenues and using resources during the year (Box 2).

Box 2: What is a budget?

- A record of the past
- A plan, a statement about the future
- A mechanism for allocating resources
- An instrument for pursuing efficiency
- A means for securing economic growth
- An engine of income distribution
- A precedent
- The result of political bargaining
- The most operational expression of national policies in the public sector

Wildavsky, A. (1975) *Budgeting: A Comparative Theory of Budgetary Processes*. Boston: Little, Brown and Company.

Budgets are fundamental for meeting three important policy objectives:

- a) **Aggregate fiscal discipline:** Decisions about total revenues, expenditures and financing arrangements shape the size and form of government intervention in the economy. In order to avoid accommodating all spending demands, aggregate expenditure ceilings should be set before any decisions on individual components of the budget, and should be sustainable over the medium-term.
- b) **Allocation of resources consistent with strategic policy priorities:** Expenditures should be based on the strategic priorities set by the government, and on considerations of effectiveness and equity. This requires a coherent linkage between policy, planning and budgeting both at the intra- and at the inter-sectoral level.
- c) **Efficiency and effectiveness in implementing activities:** government agencies should utilise budgetary resources in order to maximise their tangible outputs and outcomes. Predictable disbursements, building adequate capacity and

correcting perverse institutional incentives can assist in this respect.

Aaron Wildavsky's definition of budgets as 'attempts to allocate financial resources through political processes to serve differing human purposes' points to the two main characteristics of budgeting processes in poor countries: scarcity and uncertainty. On one hand, the budget process forces public policy choices to be made, and trade-offs to be identified. However, in an environment characterised by lack of transparency and accountability, scarcity also means that budgets may be limited to wishful lists of political promises, which then remain unfulfilled as hard budget constraints start to bite during the course of the financial year, or are financed through means that put fiscal stability at risk.

At the same time, the complexity of the environment in which budgets are formulated and implemented often results in a high degree of uncertainty about actual budget outcomes. Financial shocks, political turmoil and natural emergencies can have a deep impact on normal budget practices, resulting in shifting priorities and ad-hoc measures which undermine the predictability and significance of the budget as a policy statement and guide for government action (Box 3).

Framing Policy: Budget Formulation

Through the budget formulation process, each government is forced to make a number of choices regarding the financing of public expenditure (through revenues, aid, debt, etc.) and the allocation of available resources to existing or new programmes and institutions. Budgets can therefore provide a very clear statement of intent, often more accurate than the policies or plans on which they are based, about the priorities and commitments that a government wants to adhere to. Given that resources are limited, budgets determine who are the winners and losers in the resource allocation process. These choices and trade-offs are sometimes based on technical considerations, but more often are the ultimate outcome of a complicated interaction between different

Box 3: The theory and practice of budgets in poor countries

GOOD BUDGETING PRINCIPLES...

1. **Comprehensiveness:** the budget must encompass all the fiscal operations of the government
2. **Discipline:** policy decisions with financial implications must be made against the background of a hard budget constraint and in competition with other demands
3. **Legitimacy:** decision makers who can change policies during implementation must take part in and agree to the original policy decision
4. **Flexibility:** decisions must be pushed to the point where all relevant information is available
5. **Predictability:** fiscal policy must take account of the need to ensure the timely flow of funds to spending units
6. **Contestability:** existing policies are subject to constant review and evaluation
7. **Honesty:** budgets are based on unbiased projections of both revenue and expenditure
8. **Information:** accurate and timely information on costs, outputs and outcomes is essential
9. **Transparency:** information about budget decisions must be accessible, clear and communicated to the wider community
10. **Accountability:** decision makers must be held responsible for the exercise of the authority provided to them

Source: Public Expenditure Management Handbook (1998) World Bank.

... AND POOR BUDGETING PRACTICES

1. **Unrealistic planning/budgeting:** both plans and budgets are not a statement of intentions, but a wish list of political promises
2. **Short-term budgeting:** no consideration of medium-term implications of budgets, such as the recurring operating costs of new investments
3. **Repetitive budgeting:** the budget is frequently remade during the year, in response to economic or political conditions
4. **Cashbox budgeting:** government spends as cash becomes available, not according to preset budget priorities
5. **Deferred budgeting:** arrears build up as expenditures are pushed into subsequent years
6. **Distorted priorities:** scarce resources are spent on 'showcase' projects that produce meagre social returns
7. **Declining productivity:** the size of the civil service expands in response to unemployment, but ghost workers, underinvestment in training and IT, and poor working conditions degrade operational efficiency
8. **Informal management:** extralegal arrangements dictate how government operates in recruitment, procurement, etc.
9. **Corruption:** lack of enforcement of formal rules breeds illegal behaviour, which goes undetected and unsanctioned

Adapted from A. Schick (1998) *A Contemporary Approach to Public Expenditure Management*. World Bank Institute.

interest groups and constituencies, ranging from cabinet members to government departments, from economic lobbies to civil society groups. Therefore, they often involve a compromise between 'optimal technical solutions' and the reality of politics and interests within the country.

Box 4: Summary results of CAPE research: How, When and Why does Poverty Get Budget Priority

A study of five African countries found that efficient and effective public expenditure management is an essential precondition for governments to be able to tackle poverty. Other conclusions from the study are:

- Many of the problems of ineffective budget management that undermine the ability to re-orient spending towards the poor, stem from political reluctance to recognise the need for tough choices and budget discipline
- The PRSP process helps to reinforce the position of reformers wishing to enhance and preserve allocations important to the poor
- A good analysis of poverty issues positively influences poverty policies
- Governments need to integrate budgeting and planning functions in order to prioritise public expenditure needs
- Governments must ensure that actual expenditures reflect budget priorities
- The sharing of information and a pro-active approach to participation helps to improve the effectiveness of poverty policies

Source: Foster, M. et al. (2002) 'How, When and Why does Poverty get Budget Priority: Poverty Reduction and Public Expenditure in Five African Countries'. Working Paper 168. London: ODI.

Making Things Happen: Budget Execution

Much attention in government circles is often directed at drafting policies and plans. However, it is the actual allocation of resources for these plans that allows the implementation of activities, and their transformation into development outcomes. Budget implementation deals with the transformation of numbers in the budget books into actual delivery of outputs and successful achievement of government objectives. Ensuring that public funds are spent in a way that results in objectives being met, and in higher degrees of efficiency and effectiveness, involves managing the interactions between a range of actors, including government agencies at different levels, contractors, clients and service providers, including NGOs and private sector firms. These interactions are guided by complicated systems of rules, procedures and incentives.

While budget allocations may be a good indicator of government intentions, how the money is actually spent (budget outturns) can reveal a lot more. Budget implementation is again the outcome of a combination of political and technical processes. These include: (i) the realism of the budget figures, which is a function of the government's capacity to accurately forecast variables such as growth and inflation rates and revenue levels, as well as its capacity to implement programmes; (ii) the honesty of the budget, or the degree to which it is free from arbitrary manipulation, which can come from political pressures or lack of transparency; and (iii) shocks and flexibility, reflected in the capacity of the budget to adjust to sudden changes in priorities or availability of resources coming from external circumstances.

Listening to Voices: Budget Accountability

Under the principle of 'no taxation without representation',

tax payers have a right to participate in and be informed of the government's decisions regarding the use of public resources. This is a basic tenet of democratic societies. However, very often the lack of transparency and of adequate accountability measures keep this principle quite far from common practice. Often budgets, along with the technicalities of public financial management, are all but incomprehensible to the average citizen. There is a need to hold governments to account for their budgetary promises and actions, through a variety of mechanisms such as civil society participation and capacity building, the enhancement of the role of parliaments in the budget process, transparency measures that allow for information to be disseminated and shared, and auditing procedures which ensure adequate ex-post control. Opaque budgets and inadequate controls can seriously undermine the democratic process. International aid sometimes can have a similar effect, by distorting accountability structures and rendering governments more responsive to the needs and views of donor agencies than to those of their citizens.

Important Areas for Future Policy-Oriented Research

Aid and Budgets

Many developing countries are heavily dependent on aid resources. In some cases, aid can constitute the source of financing for more than half the national budget. This often imposes additional strains, not only in the budget formulation process, which needs to take into account the priorities of the various donors involved, but also on the implementation side, where multiple financing sources may mean separate implementation and reporting procedures, and multiple accountabilities. As noted above, the new aid agenda focuses on country-led approaches, moving away from project assistance to more government-friendly processes. This not only means that budgets become more important to donors, but it makes donor behaviour a critical factor in the budget process, further increasing the relevance of the alignment and harmonisation agenda.

Box 5: Summary results of CAPE research: Results-Oriented Public Expenditure Management

Low-income countries are making some real progress in the realms of performance budgeting and management. Such initiatives are likely to play a vital role in the successful implementation of poverty reduction strategies. This cross-country study found that:

- Conditions favouring the introduction of a results-oriented culture include effective political leadership and a unified institutional approach to performance management
- Ministers of finance are best placed to provide leadership and direction in such matters
- Results-oriented processes are often initiated via sector-wide approaches, especially in health and education
- Sample countries showed better aptitude for setting targets and performance indicators than for monitoring, evaluation and policy feedback
- Significant pro-poor policy change can be implemented with the aid of informational, analytical and resource-management tools provided by results-oriented practitioners, even in low capacity environments

Source: Roberts, J. (2003) 'Managing Public Expenditure for Development Results and Poverty Reduction'. Working Paper 203. London: ODI.

Box 6: Summary results of CAPE research: *What's Behind the Budget?*

The literature on public expenditure management focuses largely on technical processes. That needs to be accompanied by a broader understanding of the political context, and more emphasis on the spaces and capacities needed for civil society to ask questions of public policy and implementation systems, and the capacity of the disadvantaged to make claims for service outcomes. This study highlights some factors that facilitate accountability and a gender-sensitive, pro-poor focus in the budget process:

- A constitutional framework and political culture oriented to citizenship and rights
- A system of issues-based political competition
- Sufficient fiscal resources for wide-scale delivery of some basic services
- A clear framework of policy goals, aligned to a vision of society with respect for social justice
- Transparent systems of decision-making about budget allocation, and of budget execution
- An active, engaged civil society that is able to access information, produce analysis and hold government to account
- Active, informed citizens able to use services, make claims and hold providers and policy makers to account

Source: Norton, A. and D. Elson (2002) *What's Behind the Budget? Politics, Rights and Accountability in the Budget Process*. London: ODI.

Against this background, two large topics call for research:

⇒ Following the commitments made at the Monterrey Conference in 2002, aid flows may increase substantially over the next few years in the drive to achieve the Millennium Development Goals by 2015. What is the possible impact of such a large increase in foreign assistance for recipient countries? Are the benefits likely to be offset by macroeconomic imbalances? Can increased resources be effectively transformed into development outcomes, given existing limitations on absorptive capacity?

⇒ The ongoing shift in aid thinking implies substantial changes in the practices and behaviour of donor agencies, and an assessment of their impact on recipient governments. To what extent, and in what conditions, are current donor practices influencing aid effectiveness negatively? How can incentives affecting the behaviour of donor agencies be analysed to ensure that they support and reinforce the current trend towards country ownership, alignment and harmonisation?

Poverty and Budgets

Budgets, and how public funds are raised, allocated and managed, are the main avenue through which governments channel resources for carrying out their functions, including poverty reduction. The recent experience in the implementation of PRSPs has demonstrated that the links between policies, budgets and poverty impact are still weak. Difficulties arise in translating plans and policies into effective poverty reduction interventions, whether through the delivery of basic social services or through the creation of a conducive social and economic environment. This indicates a need for further research in two areas:

⇒ Assessing the poverty impact of public expenditure is no easy task. Policy makers in poor countries often do not

have access to the necessary tools and techniques to make informed budgetary choices. Can existing knowledge about the linkages between public expenditure and poverty reduction be brought together, and be used as a basis to devise practical tools to help decision-makers turn national budgets into more effective instruments for pursuing poverty reduction objectives?

⇒ Developing countries are being encouraged to delegate responsibility for service delivery to local governments. Although basic services are increasingly provided either by or on behalf of local governments, tools to improve the efficiency and effectiveness of service delivery have focused on central government. To what extent can decentralised pro-poor service delivery be enhanced through the application of performance budgeting and management techniques?

Politics and Budgets

There is a growing consensus that public expenditure management is a political, rather than a simply technocratic process. Studying the politics of the budget process includes examining the ways in which the distribution of power affects the subsequent distribution of public resources. Reforming public expenditure management systems so that incentives are aligned with sound budgeting principles, and promote a pro-poor focus, is also an intrinsically political process, with winners and losers. Different PEM reforms are likely to require different levels of commitment and expertise from technocrats and politicians. Developing countries and donors alike have a limited understanding of which PEM tools are available and appropriate in which political and institutional environments, and how their implementation is best sequenced. The choice of instruments should not just depend on an assessment of institutional capacity, but also reflect an understanding of the underlying political and institutional environment and incentives to reform.

This too is an area where research is badly needed:

⇒ A deeper understanding of how political realities and actors influence budgetary processes and reform efforts could provide much-needed guidance on the choice and sequencing of interventions, for governments, other local actors and donor agencies. Can an analytical framework be developed to capture the main features of the political economy of public expenditure management? How could such a framework be applied to country cases in order to improve the planning and implementation of reform initiatives?

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