SIGMA
Policy Briefs

SIGMA Policy Brief No. 1:

Anatomy of the Expenditure Budget

Introduction

Creating effective, modern budgetary processes and institutions is of great importance to the countries of Central and Eastern Europe. Key “building blocks” include organic budget laws; accounting systems and classifications; cash management and treasury systems; and financial information networks. Such laws, institutions and systems are essential to:

- facilitate the setting and implementation of **fiscal policy goals** (eg on budget deficits and debt) that are an important component of a country's macro-economic policy;
- create **a crucial bridge with the policy-making process** so that the financial impact of alternative policy options (eg major capital investment projects) on the budget and the economy can be measured and compared;
- enable **in-year monitoring and control of the budget** so that, for example, if public expenditure is higher than forecast, corrective action can be taken;
- support government efforts to build effective **defence mechanisms against fraud and corruption**, by creating a more transparent, open system that can easily be controlled and audited;
- assist the government in **managing the borrowing and debt of local authorities;** and
- help countries achieve standards of budgeting and financial control that are necessary in order to gain **accession to the European Union (EU).**

This SIGMA Policy Brief describes the characteristics of modern budgeting systems that satisfy the requirements set out above.

A Cornerstone of Good Governance

While little remarked by the public, it is a practical fact that all daily operations of any government are inextricably bound up with budgeting. Arguably, what is good for the health of the budgeting system, is good for the health of the overall system of governance.

In EU Member States, the struggle to meet the Maastricht criteria focuses on budget discussion. Similarly, there are strong pressures on the central and eastern European countries to strengthen budget discipline in preparing for EU accession. As one example, the classical principle of budget comprehensiveness states that all public money should be accounted for in the budget. What then should be done about social security funds or government guarantees which some countries keep “off-budget” when calculating the debt or deficit? As another example, the question of whether the criteria for monetary union are sustainable in future years raises the issue of permanently appropriated entitlement programmes. These offend the principle of annual voting and, as a practical matter, greatly reduce the discretion of both parliament and executive to deal with future problems.

OECD Member countries in and outside Europe share similar concerns. The budget has become the vehicle for debates on the changing role of the state and on new relationships among social partners. New types of institutions are being created to deliver public services, and debates rage about how much decentralisation can be tolerated while maintaining control and accountability. Facing the imperative to do more with less, the function of public administration is being redefined to emphasise creative results-oriented behaviour in place of the traditional mandate to do little more than follow the letter of the rules and regulations. Does the extra discretion given to administrators undermine the authority of parliament as some critics charge? Systems and safeguards built up over the years to combat corrupt administration are being dismantled in the search for efficiency. Are their replacements dependable?

The Balance of Powers

Effective budget management begins with a carefully balanced division of responsibilities between the parliament and the executive government (referred to in some countries, and in this paper, as “the council of ministers”). Competition for budgetary power is common but the tension between these two institutions is accepted as one of the vital checks and balances of democracy.

What is not often appreciated is the full extent of the complementarity of their roles. With a well-designed constitution and organic budget law, the powers of each are made to reinforce the other.

Parliament

It is an accepted criterion of democracy that the elected parliament holds “the power of the purse”; ie it must authorise all expenditures, all borrowings, and any revenues to be collected through the power of the state.

In an apparent paradox, parliament's power is reinforced by granting strong authority to the executive government and ministry of finance. Parliament acts by holding the executive accountable. But if the council of ministers does not itself possess the tools or the powers of command over public money, parliament's control of the executive is left with little meaning. Hence the paradox.

The most fundamental issue is the extent of parliament's power to amend the budget. In the only example of its kind, the United States Congress has virtually unlimited powers in budgeting. Frequently, it discards entirely the draft budget submitted by the president and, taking advantage of its own extensive research resources, compiles a quite different budget. At the opposite extreme, in some countries within the Westminster tradition, the parliament is forced to approve the budget without amendment or else defeat the government and cause an election.

A more equitable balance is found in most EU Member States, where parliaments are allowed to reduce or increase spending and taxes by voting amendments, but only within strict limits, such as, for example, that the deficit may not exceed the target proposed by the government.

Two other legislative practices are being reconsidered in European and other OECD Member countries -- namely, permanent appropriations and very detailed programme laws. The first of these procedures, sometimes called “entitlement spending”, has helped produce major deficit problems and creates a strong case for restoring annual voting for certain expenditure programmes. The second procedure, reflecting parliaments effort to extend its reach into day-to-day administration of programmes, has been found to create the very rigidities and inefficiencies which all governments are trying to eliminate.

In keeping with the paradox noted earlier, a parliament which makes many amendments to the budget or imposes micro-management details in law undercuts its own ability to criticise the council of ministers later if those arrangements turn out badly. Central and eastern European parliaments, therefore, are well-advised to design the constitution and the organic budget law to ensure a sound balance between the legislative and executive powers. They should limit their own intrusions in the executive role, for which they are ill-equipped, and instead emphasise strong and effective review procedures (eg audit) and other measures for holding the government to public account.

Council of Ministers

The council of ministers constitutes the key decision-making body at the centre of government. It approves the main budget parameters and targets on the recommendation of the finance minister; sets priorities for spending; decides major policy issues; resolves budget disputes between the finance minister and his ministerial colleagues; and approves the draft budget for submission to parliament.

It must be noted that much of the council of ministers' power stems from the fact that it has an exclusive right to present the budget to parliament. This is where parliament's authority reinforces that of the council of ministers. Since no minister can go to parliament independently to seek funds, all are bound to submit their spending plans to the collective judgement of their colleagues.

The dynamics of the council of ministers role in budgeting may be usefully seen as the conflict between the interests of the ministers as a collective body and the interests of ministers as individuals. The most basic interest of the council as a collective body is to retain the confidence of parliament and stay in power. How it taxes and spends are dominant factors in its success or failure. In the nature of things, the individual minister favours ever-increased spending within his sector, a view which conflicts directly with the council's collective interest in holding down taxes and borrowing while directing spending to the politically most important priorities.

Thus, in successful governance systems, the council of ministers has assigned to the ministry of finance very special powers and prerogatives to enable it to act as defender of the collective governmental interest. In a very real way, this ministry works to protect ministers from themselves. This also explains the natural close alliance which exists in most countries between the prime minister and the finance minister.

The discipline of the budgeting system relies on the effectiveness of this key axis between the only two members of the council of ministers whose full-time job is guarding the collective interest. In some countries, an explicit budgeting role for the prime minister is defined in the organic law, but in most cases the special relationship takes the form of continuous consultation and development of firm bilateral agreements on major issues.

A recurring temptation for ministers in all countries is to ease the pain of budget-making by replacing professional forecasts with politically more acceptable numbers. In many countries today, councils of ministers are sadder but wiser after inheriting the budget problems caused in part by past political tampering.

For example, if the revenue forecast is inflated it permits spending targets to be raised; and higher spending is regarded everywhere as good short-term politics. Or, if economic growth forecasts are inflated, projected unemployment figures will fall, another piece of the good news which all politicians prefer. But such practices are always self-defeating in the long run. A number of governments now remove themselves from temptation with rules requiring the budget to be built on “consensus” forecasts using those from authoritative non-government sources alongside finance ministry figures. Its value proven by these experiences, these rules would be a healthy addition to reforms planned in Central and Eastern Europe.

Ministry of Finance

Ministries of finance are nowhere loved but almost everywhere respected. To be effective as the guardian of the collective fiscal integrity of government, the ministry of finance must have powers and tools much stronger than other ministries. At the same time it bears the special burdens of being the collective conscience, not only by saying “No” frequently to maintain budget policy positions, but also by actively helping to design and evaluate key national programmes, and by demonstrating ethical and transparent behaviour in its relations with spending ministries, parliament and the public. Such endeavours are in keeping with the finance ministry's privileged position as steward of the taxpayers money.

What are the key powers in expenditure budgeting which the long-established democracies have accorded to the ministry of finance? A fundamental power is the custody and management of all public money (treasury function) which enables the ministry of finance to monitor and control the implementation of the budget. A second is the authority to regulate accounting standards, financial management procedures and closely related personnel and administrative activities. A third is to have right of access to any information from other ministries and agencies which the ministry of finance deems necessary for analysis and control. A later section describes essential tools for the exercise of some of these powers .

The most important power, however, is to prepare the draft budget and thereby to maintain a near-monopoly over financial requests going to the council of ministers. This bears comment because it is found in all countries but not always with the same effects. For example, under a central planning system, the budget prepared by the ministry of finance may be nothing more than a mechanical assembling of numbers resulting from decisions already made in planning offices, line ministries and public enterprises. In typical EU Member State governments, however, the ministry of finance is given strong authority to act as “gatekeeper” to the council of ministers on all financial proposals and thus to discipline the whole budget process

Note that this rule parallels the earlier one which gave the council a monopoly in presenting budget requests to parliament. It also completes the three-level hierarchy of mutually supportive powers which was described earlier as a paradox, as follows: parliamentary accountability is enhanced when the executive government has strong authority over public money; council of ministers authority comes in large part from its monopoly of requests to parliament; the councils collective strength is ensured by a strong ministry of finance; and the ministry of finance derives institutional strength from being an exclusive channel for funding requests to the council.

No government of an OECD Member country keeps absolute this particular prerogative of the ministry of finance, although all of them honour the principle in some fashion. In some countries, the originating ministry must obtain prior approval of the ministry of finance to submit a proposal with budgetary implications to the council of ministers. In others, every submission to the council must contain a complete financial analysis which the ministry of finance has endorsed as accurate. A widely accepted minimum rule is that the ministry of finance must have sufficient advance notice to complete its analysis of the proposal and that the item cannot be considered at a meeting of the council of ministers if the finance minister is not present or represented.

Budget management and control is, of course, not the exclusive responsibility of the ministry of finance. Preparing the annual budget, under strictly defined “rules of the budget game”, requires a continuing dialogue between the ministry of finance and line ministries. And line ministries are responsible for managing and controlling their own budgets -- with greater or lesser degrees of autonomy, depending on the extent to which the budgetary system is decentralised -- subject to oversight by the ministry of finance.

Basic Tools for Expenditure Budgeting

The expenditure management responsibilities of the above institutions serve the three main aims of the budget: to maintain control of total spending; to ensure resources are allocated in accordance with government priorities; and to improve the efficiency with which programmes are designed and delivered. In the common experience of European and other OECD Member countries, a number of systems and institutions have been found indispensable, though they be found in a variety of forms and under different names in individual countries.

Public Money - Cash Management - The Treasury

If the executive government, through the ministry of finance, is to have full command and control of the budget during planning and execution, it must have control of the actual cash. If powers to collect, store, and spend money are spread among many ministries and agencies rather than concentrated in the ministry of finance, then the council of ministers, as a collective body, cannot claim to have real control. Most governments solve this problem by means of a law which defines “public money” and establishes that all such money must be deposited in a single account.

Public money means all money belonging to the state including duties and tax revenues, borrowings, and fees or charges arising under a government programme. Custody of the single account and the operation of all transactions affecting it is assigned to the treasury or equivalent institution coming under the authority of the finance minister. The treasury is usually given responsibility as well for the management of government debt, and often for certain government assets.

Accurate and Timely Information - the Accounting Systems

Day-to-day decisions about borrowing and spending can be no better than the information upon which they are based. The analyses necessary to carry out forecasts, to allocate resources for specified purposes, to promote efficiency and control implementation depend on accurate, informative, timely data in standardised accounting categories. The procedures for collecting information on receipts and disbursements may be centralised or decentralised depending on a country's size and its legal and administrative system.

For cash and debt management purposes, the accounting system must capture a limited set of key data very precisely and report to decision-makers within delays as short as 24 hours. To meet broader needs in budget planning and implementation, government accounting classifications must be established which render the data meaningful for economic and financial analysis, analysis by purpose (function/activity), by responsibility centre, by project, etc. While serving the budget, this is the accounting base also for good reports to programme managers. And the accounts take on international significance when the numbers support treaty obligations with the EU, World Trade Organisation and other inter-governmental organisations.

Accounting systems adequate to these purposes can only be created under the guidance and control of a central government body which has power to set accounting principles and standards, and to monitor and enforce their use throughout government. In most countries, this is the ministry of finance or a separate financial control body reporting to the finance minister. Whatever the body with central authority, it is bound, in defining the governments accounting standards and practices, to take account of the needs of the other central organisations which are major customers of the accounting system: the finance ministry, national statistics office, supreme audit institution, national bank, etc.

Sub-Systems for Dominant Expenditure Classes

While their details are beyond the scope of this paper, it must be emphasised that the budget depends on a variety of supporting systems, including: the civil service law; institutions and regulations which determine the number, rank and salaries of public sector employees; the system for selecting, prioritising and controlling public investment projects; the laws and processes governing the procurement of goods and services; statistics of adequate scope and integrity; and economic and financial modelling.

Control During Budget Implementation

The quality of administrative performance during the execution of the budget determines whether the goals and expectations embodied in the budget plan are achieved or whether taxpayers money is wasted, stolen or spent for unintended purposes. The requirement is for skilful and responsible management in all public spending organisations. All democracies with advanced market economies, however, will possess two central mechanisms which have been found essential to support effective budget implementation -- *management control* and *external audit*.

Management Control (or Internal Control)

Management control can be briefly defined as the organisation, policies and procedures used to help ensure that government programmes achieve their intended results; that the use of resources to deliver those programmes is consistent with the stated aims and objectives of the organisations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making.

Also called “internal control”, it is only during the past 25 years that these principles have been conceptualised and codified as a function integral to administrative management. The remarkable value of these techniques is that they prevent errors, detect errors which have occurred, and correct errors which have been detected. This contrasts with traditional auditing techniques which concentrate on detecting and assigning blame for errors rather than on prevention and correction.

Essential ingredients of this approach are underlined in its two names. The term “management control” emphasises that designing and implementing these practices is the job of the management of an organisation; it is not the job of auditors or outside inspectors. And the term “internal control” emphasises that control takes place inside, not outside, the organisation. Internal control is part of the work rather than a separate after-the-fact check of the work. Each level in the hierarchy of administration

-- parliament, council of ministers, ministry of finance, government control office and top management of spending organisations -- must contribute, in a manner appropriate to its responsibilities, to the establishment and operation of the management control system.

External Audit by the Supreme Audit Institution

In every democratic country, the circle of parliament's budgetary authority is closed with the approval of the final account and the report of the supreme audit institution (SAI), be it called auditor general, national audit office or *cour des comptes*. The important factors are that the SAI is responsible only to parliament, that it is independent of government or other political factions and that it possesses high professional skills. In EU Member States, the SAI carries important additional responsibilities to report on the use of EU funds and to co-operate in the work of the European Court of Audit, further underlining the importance that it be seen to be independent and meet international standards of professionalism.

Traditionally reliant on detailed reviews of transactions to establish the accuracy and regularity of financial behaviour, the spread of the internal control philosophy in EU Member States and other countries has been spearheaded by SAIs and has led to vast changes in their own auditing techniques.

In keeping with the principles of management control, modern SAIs spend little time reviewing the huge volume of data on individual transactions. Instead they review the systems, procedures, organisation structures and work practices to diagnose whether or not they are effective in preventing errors and achieving value for money. The SAI publishes reports which include recommendations on measures that should be taken to strengthen control systems, thus preventing errors and irregularities from occurring. In this way, SAIs better serve parliaments than by using up their scarce resources chasing faulty transactions which have already occurred and gathering evidence to apportion individual blame.

Organic Budget Law

An effective organic budget law (OBL) provides the indispensable legal base for all key roles and relationships described above, as well as creating the competence and conditions necessary to establish key tools of the expenditure management system. An OBL necessarily contains many elements, balances many interests and priorities and yet harmonises with the constitution and other organic legislation.

The most frequently controversial feature of an effective OBL is the array of special powers and prerogatives conferred on the ministry of finance. This feature is often resisted strenuously by line ministries and by the sectoral interest groups behind them. It may be resisted also by parliamentarians anxious to preserve their own power although, as noted earlier, this is sometimes a misguided argument.

The objective should be an OBL which strikes a balance capable of sustaining effective management of state expenditures in the longer term. Parliaments and governments are well-advised to give the ministry of finance all the authority and prerogatives necessary to do the difficult but vital job of managing public money.

This power should be balanced with clear accountability for the ministry of finance. In particular, there must be complete transparency in the reporting of budgetary matters to the council of ministers; presentations to parliament must be fully informative and also comprehensible to the lay reader; rules preventing transfers between chapters approved by parliament must be rigidly observed; and decisions on the allocation of budgetary reserves and the spending of emergency funds must be promptly reported to parliament. Moreover, parliament must have effective means for ensuring that the government is held to account by means of debates on the annual budget; year-round surveillance activities by parliamentary committees; the review of the final account; and procedures for reviewing reports on government activities by the supreme audit institution.

Starting from an effective and durable division of roles, the organic budget law can become the basis for sound management of the nations finances and, as such, a strong buttress for ethics in administration, efficiency in management, and responsiveness in services to the public -- in short for many important qualities of good governance.

Further Reading

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About this Publication

The SIGMA Programme launched the Policy Briefs series in August 1997 to make public policy subjects accessible to a wide audience interested in governance in Central and Eastern Europe. The Programme draws upon its extensive international network of experts to write these concise documents, which provide non-specialists and specialists alike with comparative information on important matters affecting citizens in all democracies.

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