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**Erosion of Expenditure Management System:
An Unintended Consequence of Donor Approaches**

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Abstract

The paper considers the various procedures and practices relating to budgeting and accounting of foreign aid, and points out that as a result of the high degree of ringfencing associated with the aid, a kind of functional dyarchy has emerged with serious implications for expenditure management in the recipient countries. It concludes that more structured negotiations, improved information systems as well as performance agreements have the potential of avoiding the problems now encountered.

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SUMMARY

Foreign aid is of several types and every type has its own specifications about how it is to be used and about the budgetary and accounting procedures to be adopted. In a number of countries, the aid received, with the exception of technical assistance given as a grant, is included in the budget, and annual accounts are compiled. In other cases, however, aid is organized, partly at the request of the donors, into extrabudgetary accounts outside the scope of the expenditure management system of the recipient countries. Even when aid is included in the budget, some areas remain opaque.

In general, however, donors' insistence on the application of the budgetary, accounting, and reporting procedures they have developed has resulted in recipient governments having, at a minimum, two systems--one its own and another required by the donor, resulting in a kind of functional dyarchy. Spending agencies now prefer to receive aid-in-kind directly from the donors, bypassing the local budgetary and accounting systems. More significantly, donors' demands may have contributed to debudgetization. As a result, financial discipline in the host government is undermined.

In the interest of pursuing proper macroeconomic policies, not to mention the need to restore the credibility of the local expenditure management system, it is appropriate that explicit attention be paid to strengthening the negotiation process between donors and recipient countries. Furthermore, greater investment in developing information systems in recipient countries is likely to benefit both sides. As an integral part of this effort, the links between borrower and lender could be embodied in a performance agreement that will provide the requisite autonomy to the borrower, while holding him accountable for results.

I. INTRODUCTION

Foreign aid, including technical assistance, received on a bilateral and multilateral basis has come to form an important element of the receipts structure of many developing countries. The aid received ranges from about a quarter to about one third of the total budgetary resources of some governments. Reflecting this magnitude and related areas of shared decision making, both host governments and donors have evolved, over the years, sophisticated administrative systems to address the issues of planning, budgeting, programming and accounting of aid. These procedures reflect the administrative needs as well as the legislative requirements of the donor and recipient countries. The adequacy of these administrative systems varies from one country to another, as do the opinions about them. Some take the view that some of the procedures are too elaborate and, in several cases, disproportionate to the size of the aid and that they often contribute to long delays in the implementation of the approved projects, in turn contributing to slow utilization of aid and deferral of estimated results. There is also the view, on the other side, that there is inadequate appreciation of the donor requirements. Legislators both in donor and recipient countries comment that the accountability of foreign aid leaves a good deal to be desired.

During recent years, certain types of foreign aid, particularly aid provided in kind, has tended to reach, in some countries, to the spending agencies in the government without the involvement of the central agencies, and frequently outside the financial management processes of the country. In a few other cases, the aid received is accompanied by a high degree of ringfencing that it has contributed to parallel approaches in budgeting and accounting. A consequence of these approaches, it is argued in the following sections, has been a breakdown of the expenditure management system with serious erosion of accountability and, finally, an undermining of the overall credibility of both the government and its capacity to manage the country's finances. This is further exacerbated by the rapid, indeed accelerated, development of an enclave mentality in the spending agencies that have the responsibility for the implementation of the approved aided programs and projects. It could be argued that endowing the requisite administrative flexibility in the agencies could contribute to a quicker implementation of the projects. This proposition is however, debatable and the value of aid tends to be diminished when evaluated in the context of the more enduring impact on a weakened expenditure management system.

If the conclusion of the paper that the expenditure management systems have seriously been eroded by the above referred approaches is tenable, then it is appropriate that concerted action is taken both by the donors and the recipient countries to strengthen the systems. Both the receiving countries and the donors have a strong commitment to improved governance through transparency and accountability. And to the extent that improved expenditure management is at the heart of transparency and accountability, it is imperative that measures are taken to build sustainable expenditure management systems.

The issue may be raised whether the consequences on the expenditure management systems could not have been anticipated by those engaged in aid negotiation. For the purposes

of this paper, it is assumed that the above referred consequences are unplanned. Negotiations of foreign aid usually tend to focus on the nitty gritty of the projects rather than on the somewhat remote issues of expenditure management systems.

II. SCOPE OF THE PAPER

Foreign aid covers a wide variety of transactions.² Each has its budgetary and accounting procedures and specifications. The concern here is twofold: aid (either in the form of loans and grants) extended to finance the outlays on a project or a program and aid given in kind other than commodity assistance. (Aid given in the form of commodity assistance generates counterpart funds in the domestic currency of the recipient country and has its own accounting and budgetary procedures.) While some of the conclusions drawn here may have applicability to the other forms of aid as well, the focus of the paper is limited to these two types of aid only. For purposes of discussion, the different approaches of the donors as well as the recipient countries are abstracted and as such no reference is made to a country or to any donor. That said, it should be noted that the abstractions are based on actual cases that have been examined during the course of providing technical assistance.

Another caveat should be noted. The procedures and approaches discussed in the paper are based on casual empiricism rather than on any field study specifically designed for the purpose. The conclusions in this paper have been verified during the course of extensive discussions with policy makers and those engaged in the day-to-day management of the aided projects and programs.

III. PROCEDURES AND PRACTICE

The procedures and practices vary among the donors and the recipient countries. For the sake of analytical convenience, these may best be examined in terms of budget planning and formulation, budget implementation, accounting, and other aspects.

A. Budget Planning and Annual Budgets

The existing practices insofar as projects and programs are concerned may in turn be broadly divided into three groups: (i) countries that maintain a separate consolidated aid fund into which all aid flows are credited and debited as the amounts are spent; as with other transactions, these are appropriated, indicating the annual amounts that may be spent, and the approval of the Legislature is obtained for the associated legislation. Very few countries have this practice; (ii) countries which include all the aid flows in their consolidated fund and

²For a detailed discussion of the various types of foreign aid, see Premchand, (1995), pp.90 et seq.

therefore prepare and submit budgets inclusive of the aided projects and programs; the budgets show the amount of aid expected for each project, amount of local currency expenditure, amount of expenditure funded by the counterpart funds that may have been set up from the previous or continuing loans from the donor, and the amount of loans and grants secured from the donor for the purpose. These outlays are appropriated by class of items or program depending on the legislative framework and legal traditions of the country; and (iii) countries that organize the loans and grants into extrabudgetary funds and are therefore budgeted and accounted for independently from the main budget. The procedures in some of the former centrally planned economies continue to be different in that the outlays, even of the traditional type, are not as yet appropriated by the Legislature, but are approved in broad magnitudes by the party congress.

Two exceptions to the above groupings should be noted, however. First, military aid is, in most cases, outside the budget. Where it is included in the budget, the details are at best sketchy and the traditional opaque nature of the defense transactions continues to be a dominant feature. Second, technical assistance received as grant is rarely included in the budget of the country, although the annual reports of the government on external aid cover these transactions. From the point of view of the Legislature, the loans received, which constitute firm encumbrances on the consolidated funds of the Government, are not specifically approved. The inclusion in the budget is tacit approval of each loan. The repayment of the loans is also not required to be approved, in many cases, by the Legislatures, as these are considered as charged expenditure and therefore not subject to voting or annual appropriation by the Legislature.

Organizationally too, there are diverse practices. In some countries, negotiations of foreign aid are assigned as tasks of the planning ministries, which may also be responsible for the preparation of the so-called capital or development budgets. This could also lead to situations where the total picture of the budget emerges only after the development budget has been compiled by the planning ministries. In general, the preparation of the ordinary and development budgets proceed on parallel lines with each agency having its own budget calendar. Procedures for review and consolidation are such that the totality of the fiscal outlook becomes available only when the two budgets are put together. Such a picture will, however, have notable gaps where foreign aid is organized as an extra budgetary account or is outside the purview of the budget and therefore outside the borders of financial discipline of the recipient government. The inclusion of aided projects and programs in the budget does not by itself provide a guarantee about the applicability of the domestic budgetary or financial discipline. The donor funds are, in general, obligation-based, spread over a number of years, and therefore do not lapse at the end of the fiscal year. What is not spent in a year is available to be spent in the following years. The only additional work is that the appropriation legislation will continue, in most cases, on an annual basis. The loans and grants have their own donor specified ringfencing or conditionality. Thus, limitations such as a freeze on recruitment, are not applicable to these projects. Further, reappropriation from one project to another, even where small amounts are involved, or design changes, would require the explicit approval of the donor.

B. Budget Implementation

In most countries the annual approved budget authority is released to the spending agencies on a time slice basis--either monthly or quarterly. The aided projects and programs are, for the most part, exempt from these arrangements. Instead, two approaches are widely prevalent. The recipient government may spend the amounts from its resources in the first instance and thereafter seek reimbursement from the donor through the submission of requisite documentation. This procedure which was in vogue until recently has tended to strain the host governments' finances--a strain that was directly linked to the lag between the submission of the documentation and the actual crediting of the amounts to the receiving country. For this reason, some donors have established a system of revolving funds under which advances are provided to the country. A second method is one under which the donor pays the supplier directly on the basis of the documentation specified for the purpose. During the course of the year, the projects and program authorities are expected to submit periodic reports to the donor. Frequently, they are also subject to inspection by the officials of the donor countries.

C. Accounting

Most donor funded projects and programs insist on double-entry bookkeeping and conformity with international accounting standards. Both these aspects may, however, be at variance with the systems in operation in the recipient country. The local accounting authority is expected to compile accounts of the aid received. The coverage of the accounts is dependent on the budget coverage described earlier and to that extent may not include the transactions carried outside the budget. Apart from valuation differences, this factor alone contributes to a major discrepancy between the donor compiled accounts and those compiled by the recipient country. Moreover, the accounts relating to the flows to non governmental organizations (NGOs) are not included in the accounts of the recipient country as they do not pass through the budget. Frequently, the data compiled on the basis of the records of the customs department leave a good deal to be desired to permit a full reconciliation between the two sets of accounts.

The accounts as compiled by the recipient country are required to be audited either by the Auditor General or by approved private auditors. In either event, with a view to minimizing the organizational risk, independent standards are specified for verification and audit. The donors thus specify, in most cases, the accounting and auditing standards that are to be complied with by the recipient. Such standards may differ depending on the sector - financial, infrastructure, utility and transportation, industry and agri-business and human resources and agriculture. The intent behind these specifications is to ensure that there are viable systems of internal control in the agencies of the recipient country. The application of these specified standards is, in most cases, limited to the areas of donor interest and may thus be different from those applicable to the rest of the operations of the government.

D. Other Procedures

The donors also specify the procedures for procurement (that could involve an assessment of the viability of the agency responsible for procurement, or agencies where this task is decentralized), appointment of consultants and other personnel. In some cases, the personnel employed on these aided projects may be paid dollar salaries (although they may be otherwise employed by the recipient country). They are given vehicles (outside the transport pool) and may be having office buildings which are more reflective of the Western rather than local standards. In all of these aspects, the extensive and detailed specification of requirements may involve radical departures from the prevailing practices in the non-aided sectors.

IV. ISSUES

The issues that have emerged in the above type of relationships between the countries and donors are several. From the point of view of expenditure management in the recipient country, the experience shows that there is very little convergence between the economic and organizational approaches of the donors, and where donors have specific organizational approaches, they would appear to be based on "beliefs" that are still in need of empirical verification. This can be attested from specific items discussed below.

(i) Donors generally insist on having a medium-term commitment of the authorities in regard to the projects and programs proposed for aid financing. The promises of the donors however, frequently tend to be short term as their own aid appropriations approved by the respective legislatures are on an annual basis. To that extent, there is a dysfunction between needs and actual processes. Meanwhile, expectations are aroused, advance plans made and lobbies arranged in anticipation of aid that may lead to disappointment when the expectations are not sustained.

(ii) Donors insist on their own accounting and reporting procedures. The emphasis is, more often than not, on scrupulous adherence to the specified procedures rather than on the development of the local systems that could contribute greater compliance and less transaction costs over a period. It is for this reason that many donor-insisted procedures have not taken firm roots in the local landscape. It is hardly necessary to emphasize that procedures that do not take into account the local requirements and capacities but have to be observed remain alien. The paradox in this situation is that, even in regard to double-entry bookkeeping and related and generally accepted concepts of accounting, they have not gained widespread acceptance and have been limited in their application to the donor projects.

(iii) The spending agencies in many countries now find it more convenient to approach the donors direct and with their support and sympathy, present a fait accompli to the central agencies. The donors also would appear to prefer this method to overcome, what in their view has been a centralized, unimaginative, bureaucratic approach to financial control.

The approaches of the spending agencies have contributed to a widespread enclave mentality, while undermining the control of the central agencies on the budget.

(iv) As a concomitant of the above, the spending agencies would not be averse to accept a greater amount of ringfencing for so long as their agency is the sole beneficiary of the proposed aid. Although, the conditions and controls are more in the image of the donor country, they become more acceptable than the controls of the local ministries of finance, because the former comes with money. Where such arrangements are made, information on the aid received becomes a privileged category and is limited, in terms of availability, to the donors and spending agencies. The central agencies responsible for economic coordination tend to rely, in those circumstances, more on their own wits, network of informal relations than on mandated official procedures. Agencies develop the procedures for being primarily accountable to the donors and have no incentives to meet the reporting requirements of the Ministry of Finance.

(v) The donors have, during recent years, tended to place more emphasis on NGOs to provide services to the community based on the belief that those organizations provide more value for money. While this may be so in isolated cases, a recent study concludes that the proposition that NGO's may provide cost-effective services remains to be proved.³ This has contributed to the emergence of a trilateral approach to the provision of services--services funded by the donors and provided through the budget, services funded by the donors and provided by the government agencies outside the budget, and services funded by the donors but provided by the nongovernmental organizations. While consumers should have a choice, it is moot whether this approach is the best way for providing that choice.⁴

The conclusion that emerges from the preceding discussion is that there is, in effect, a functional dyarchy in the receiving governments in that there are, at a minimum, two sets of procedures and regulatory frameworks governing the financial management systems - one that is native to the country, and another order developed to meet the donor requirements. This dyarchy has a significant impact on accountability, credibility, fiscal discipline, and decentralization, that in turn suggests that the strengths of the expenditure management system in the host countries are basically eroded.

V. ACCOUNTABILITY ASPECTS

Accountability can be interpreted in a larger context as well as in a more narrow financial aspect. In terms of the latter, it is expected that the government would be submitting

³See Edwards, Michael and David Hulme, (1996).

⁴These services, when provided by the government, constitute legitimate public expenditure.

a plan of action related to finances, and finally the accounts of the monies received and spent, to the legislature. From this perspective, however, even the aid transmitted through the budget would appear to be so arranged that the accountability picture is not complete. There is, however, an extenuating circumstance in that the powers and the procedures of the legislatures, particularly in regard to borrowing or such transactions that constitute encumbrances on the Consolidated Fund, remain to be fully developed. Consequently, the aid transactions are approved as a part of the annual budget, mostly as a means of financing. Where, however, funding is provided outside of the budget (and without the specified framework of an extrabudgetary fund), accountability is weakened as those transactions are not accountable to the legislature. Furthermore, this practice is tantamount to a violation of a principle that is almost considered sacred by constitutional experts, accountants, and auditors. This principle is that no expenditure may be incurred by government except through an appropriation approved by the legislature. Inasmuch as some aid is provided direct to the agencies without the appropriation facility, it would appear that the fabric of accountability, which is already fragile enough, is further strained.

The issue arises whether for the sake of administrative simplicity, greater damage to the accountability framework should be permitted. Approval of this approach, tacit or otherwise, is tantamount to conceding that ends justify means. Accountability, on the other hand, implies that ends should preexist in the means.

VI. CREDIBILITY

Do the above referred practices enhance the credibility of the government? Any actions that are not seemingly legal, in the sense of being reasonable, authentic and genuine, also tends to be less than legitimate and any action that lacks legitimacy erodes the credibility of the government. Further, in a more practical sense, when transactions are carried out outside the specified budgetary framework and governments have problems in getting a total picture of the transactions, the credibility of the governments tends to suffer. The impact is even worse when there is no accountability for the results of these operations. While the damage done to the credibility may be a matter of debate, what is beyond the pale of debate is the fact that conducting some of these operations outside the budget does not necessarily contribute to enhanced credibility.

VII. FISCAL DISCIPLINE

The one area which is most adversely affected is the fiscal discipline of the government. When spending agencies rush to donors and conduct negotiations with them, they are at the same time side stepping the established process for that. Commitments are made, expenditures are incurred and services provided outside the realm of the budget. Once this becomes a familiar escape mechanism, then there would be a tendency for everyone to take the same route. What also becomes a matter of debate is who is establishing the fiscal

discipline. There is a general impression, which is often backed up with documentation from actual experiences, that the reporting requirements on progress of expenditures, etc., indicated by the donors, favor hierarchical structures with a good deal of emphasis on quantitative aspects. This, as noted earlier, leads to parallel systems, each one having its own regulations and laws.

VIII. DECENTRALIZATION

Could the approaches of the donors be considered as a step in the decentralization of financial power and reducing the role of the finance ministries? It could be argued that the establishment of extrabudgetary funds endows more power, administrative discretion and management capacity in the project authorities. Where these authorities have a framework of specified objectives and quantitative indicators of performance and an independent authority to audit their work, the establishment of extrabudgetary funds could be considered as a right step forward in decentralization. In practice, however, the approaches have contributed to effective debudgetization, and to the establishment of small islands of prosperity. Decentralization need not and should not lead to debudgetization and where the latter has taken place, the advantages of decentralization are likely to be far outweighed by the disadvantages of taking them out of the budget in the first place.

From any point of view, therefore, the actual experience indicates that the donors may have contributed to a steady erosion of the expenditure management system. At a time when that system needs to be better organized, these approaches may have reduced the machinery to a hobbled giant, continuing to function more on the claimed laurels of the past than on any measures or strengthened instruments. In turn, this has adversely affected the overall management capacities of the governments.

IX. THE WAY FORWARD

Admittedly, the above problems need to be addressed frontally. This requires concerted action on the part of the donors and the receiving countries. The need for the change has also to recognize the changing winds in the management field. More specifically, the donors have to recognize the importance of trust which, as Arrow described, "is an important lubricant of a social system." Economists recognize such a trust as an important externality that increases the efficiency of the system that also generates important values held in high esteem.⁵ Such a trust is also inherent in the buyer/provider link that has come to dominate the recent reforms in expenditure management in governments. The link can also be extended with equal benefit to the relationships between the borrower/lender and performance

⁵See Arrow, (1974), p. 23.

agreements can be formulated without the intrusive presence of the donor to achieve the common objectives of both sides but within the overall economic policy framework of the recipient government. As an extension of this feature, various contractual agreements are being evolved between the buyer/provider. These agreements establish goals and objectives for the programs, their outputs, and where possible, outcomes. The outputs and outcomes permit effective monitoring and evaluation of results. More significantly, they provide additional autonomy to the agencies. As a *quid pro quo* for this additional freedom, there are some rigorous standards of performance specified as a part of the contractual agreement. The borrower/lender transactions are already codified, in some detail, in the loan agreement. It can be extended to include the autonomy needed for the recipient countries while holding them accountable for results.

To achieve the above objectives, there is a need for more structured negotiations, improved information systems, and enhanced coordination in the recipient countries. The harmonizing framework for Aid Management and Accountability developed by the United Nations⁶ explicitly recognizes that the host countries are responsible for planning and managing their development procedures. As an extension of this premise, it has to be recognized that the loans and grants extended should be in full conformity with the local laws, and in particular, the expenditure management system. In several cases, however, the expenditure management system may be weak and may not have the capacity, for a variety of reasons including catastrophic disturbances, to fulfill many of the requirements mandated by the legal system of the donor. In such events, the donors should emphasize the urgency of improving the local systems rather than exploring alternative avenues. To illustrate, if the local audit office does not have the trained personnel to undertake the required audit, the alternative is not to hire private auditors but to strengthen the Audit Department. Hiring private auditors would have the effect of undermining the credibility of the local institutions. Similarly, substitution of specialized accounting, auditing and procurement practices for the local systems and managing them along with the local systems, undermines the credibility of the latter. These aspects and their systemic implications have to be explicitly recognized in the negotiation process.

As an extension of the above, it may be worthwhile for the donors to invest in the improvement of an information system in the host country. Such an information system will enable regular monitoring of even the extrabudgetary operations (to the extent that such extrabudgetary funds are viewed as unavoidable) and bring them into the ring of financial information. Establishment of improved information systems, even within the parameters of systems of the host country, has been rendered easier and economical in view of the development of computer-based information systems. The information system will also facilitate the coordination, both within the host government as well as with the donors.

⁶United Nations, (1996), pp. 134-138.

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