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Performance Budgeting: Managing the Reform Process

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Abstract

<p>The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.</p>
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This paper examines the process of budget system reform involved in moving from traditional centralized input-oriented systems to more modern devolved performance-based systems, focusing on the constraint of limited managerial capacity. The latter is identified both as that required to operate the new system, but perhaps more important, as the change management skills required to engineer the move from one budget system to another. Based on the experience of countries that have attempted this reform, the paper identifies the principal elements of a successful change management strategy, and the lessons learned for other countries embarking on similar reforms.

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I. INTRODUCTION

The fundamental changes in budget management that have been introduced in the more institutionally advanced member countries of the Organization for Economic Cooperation and Development (OECD)—characterized here under the rubric of performance budgeting—have caught the attention of many middle-income and emerging market countries, who now seek to adopt similar reforms. The result has been that the Fiscal Affairs Department of the International Monetary Fund, as a provider of technical assistance (TA) in this area, has increasingly faced demands arising from this source. Our experience has been that while it is not too difficult to design budget reform measures, and specify detailed implementation plans, we generally face an important constraint. Namely, the management skills required by the reform process are often underestimated and not readily available. This constraint has two dimensions. First is the substantial management capacity required to operate the new type of budget management model. Second, and arguably more important, is the change management skills required to introduce new systems, to sustain reform efforts, to follow through in implementation, and to adapt to contingencies and changes in the external environment. This paper explores, from the perspective of recent country experiences, typical problems that are encountered when introducing performance-based budget management reforms.

II. THE MOVE TO PERFORMANCE BUDGETING

In the past two decades, there has been a fundamental restructuring of the budget management systems in a substantial number of OECD countries. The previous view of budget management focused primarily on resource allocation and input control, and was usually highly centralized. This approach to budget management accepted a set of policy objectives—usually poorly articulated with little attempt at quantification—and allocated inputs to reach these objectives. At the same time, central budgeting agencies focused almost exclusively on control and compliance as the primary modus operandi in budget management. There was often little follow-up in examining the subsequent performance of spending departments. The new budget management model, indicated here as “performance budgeting,” but with different titles in different countries, aimed at forging a more direct link between allocating resources through the budget and performance in reaching stated objectives.²

² See, for example, OECD (1994, 1995); Davis, Sullivan, and Yeatman (1997). Although it should be recognized that the term has a long history going back at least to the influential Commission on Organization of the Executive Branch of Government (Hoover Commission, 1949). The origins of performance budgeting are fully described in Burkhead, Chapter 6; and Axelrod (1995, pp.266 ff.). However, the new approach to performance aims at overcoming some of the disappointments of previous initiatives by adopting a more comprehensive approach that perhaps differentiates it somewhat from the past. See discussion in Diamond (2002).

This reorientation necessitated a number of changes in traditional budget management:

- Provision of increased **flexibility** to spending agencies in their access to budget funds and the uses to which funds can be put.

This concern with increased flexibility has focused mainly on the ability of spending agencies to reallocate funds within controls on budget line items. Changes are directed at giving organizations and managers greater freedom in operational decisions and removing unnecessary constraints in resource management. In return organizations and managers are held more directly accountable for results. This represents a fundamental reorientation in accountability—from the traditional model where budget managers had their inputs constrained, with no constraints over the quantity and quality of outputs, to a new situation where they are given discretion over the composition (although not the aggregate level), of inputs to meet a contracted level of outputs. Australia, New Zealand, and most Nordic countries have led reforms in this direction, and initiatives in the United Kingdom and Canada reflect the same approach. However, there are still a number of OECD countries that resist giving increased powers to public servants and are suspicious that overspending will result if they do.

Reduction of line item specificity has been a general feature of such reforms, although in different countries, increased flexibility has been provided in different ways. A first step is usually the consolidation of detailed appropriation items into wider-banded expenditure categories. The portfolio budgeting approach giving ministries greater flexibility and incentive to reallocate resources within portfolio allocations to reflect changing priorities is a more pronounced form of this approach. A minority of countries has also introduced greater end-of-year flexibility by allowing a more general carryover of unused appropriations³; and the use of net appropriations to encourage the generation of nontax revenues to finance specific types of spending. However, the latter approaches as well as resource agreements, as employed in the Australian and New Zealand systems, that allow the sale or acquisition of fixed assets, albeit a subset of assets, are still regarded as radical by most countries. It should be noted that these approaches are founded on two main preconditions: a tight budget constraint which every agency observes, and adequate capacity in the budget office to monitor developments and intervene if necessary.

- Provision of greater **certainty** in the operating environment of spending agencies, particularly in regard to availability of funds

There is usually the need to take parallel steps to increase the certainty of budget funding. Forward medium-term expenditure frameworks (MTEFs) have been recognized as useful in this regard. Medium-term budget planning has been a major development in OECD countries where fiscal targets have been set usually on a three-year rather than on a traditional one-year

³ For some countries, e.g., the United States and France, this already existed for specific categories of spending.

basis. Different approaches are evident. Australia, as a pioneer in this area, has perhaps carried the approach further by developing a forward estimate system, where refined forward estimates become the estimates of future spending rather than simply forecasts of existing policies. In this they have been followed by New Zealand. By adopting this approach, there has been a transition to medium-term budgeting. However, in some countries, budget planning occurs only at the aggregate, rather than at the agency or ministerial level where plans are just that—and are not used to give indicative allocations or limits to individual agencies and programs.⁴

- Increased **pressure** on agencies to pursue improvement in program results

Within the OECD countries, central budget offices have been increasingly reorienting their work away from compliance issues, based on detailed control of inputs, to more performance-oriented managerial issues, concerned with outputs and outcomes.⁵ In part, this reflects greater concern in improving resource allocation than meeting fiscal stabilization objectives, but also, in part, it reflects a recognition that improved program performance is as important for macro fiscal control as detailed controls on inputs. Hence, in recent years, there have been increased attempts to: integrate budgeting with other management processes; require agencies to measure performance and evaluate the results of their operations; establish new guidelines and methods for holding managers accountable; and develop the information bases and reporting systems that can enforce this accountability.

Some institutionally advanced Anglophone countries have attempted to employ formal contractual arrangements to ensure performance (for example, the New Zealand purchase agreements for outputs between ministers and agencies, or the United Kingdom's annual performance agreements between a minister and an executive agency). In this way, an attempt is made to connect budget provision directly to performance (see Box 1).⁶ In light of the methodological and practical problems they have encountered in performance measurement, other countries (e.g. Canada, Denmark, Finland, Sweden, and the United States) have introduced initiatives to promote performance without tying this directly to

⁴ On a somewhat parallel line, some countries have looked at the long-term consequences of present budget policies. For example, Italy, Norway, and the United States, have published intergenerational accounts using the methodology developed by Auerbach, Gokhale, and Kotlikoff. This approach relies on a number of rather difficult assumptions and there appears to be considerable reservation about the clarity of the message that is conveyed.

⁵ Outputs are typically physical measures of production: for example, hospital patients treated and miles of roads built. Outcomes refer to measures of policy impact: for example, fewer road accidents after reduction in speed limits.

⁶ A useful discussion of OECD experience with performance contracts is contained in PUMA, PAC (99) 2.

budgeting.⁷ This has taken the form of developing performance indicators, formalizing requirements for program evaluation, and

Box 1. The Contractual Approach in Performance Budgeting

A wide range of contractual arrangements has been developed in OECD member countries:

- Between the government and chief executive offices

An agreement that legislative appropriations are made on the basis of the agency producing an agreed level of outputs, e.g., New Zealand output agreements, where government is viewed as purchasing goods and services from a department, as well as owner of assets used by the department.

- Between minister and subordinate agency

An agreement between chief executive body and an agency on the services to be delivered and the level of performance to be achieved, e.g., U.K. annual performance agreements.

- Between the central budget office and spending ministries

An agreement that budget allocations are provided in return for agreed performance levels, e.g. Australian resource agreement where costs savings arising from new spending program will be deducted from an organization's indicative future funding levels.

- Between different levels of government

A partnership agreement between levels of government based on performance contracts, covering a variety of arrangements: joint production of a service; management of a common resources; joint investment.¹

¹ For numerous examples, see OECD, PUMA, RD (99) 4.

enhancing the role of external review agencies, such as supreme audit institutions (SAIs). It has been recognized that there are limitations to performance indicators capturing all relevant aspects dictating performance; for example, it is easier to devise and identify outputs rather than outcomes. Nor is it always clear what should be the budget implications of poor performance—how to optimize the linkage between performance and budgeting remains unresolved.

⁷ Although they supply performance information with their budgets, and all are clear that “performance” is central to it.

Among the major challenges faced by emerging market economies has been the need to adjust institutions to function in an increasingly market-oriented and global environment. With this recognition, middle-income countries have increasingly looked to emulate OECD budget reforms. Can, or should, the above reform strategy be applied generally to non-OECD countries? How universal is this reform paradigm? Do all countries have the management capabilities within government to implement such reforms? These are questions that are increasingly faced by the IMF when providing TA to middle-income countries.

III. WHAT CAN BE LEARNED FROM THE OECD EXPERIENCE?

In answering these questions, there are a number of important lessons to be learned from the OECD experience, namely:

- *Budget reform has been an evolutionary not a discrete process*

It is always as well to recognize that budget reform is an evolving process, with budget systems moving through distinct stages. It is generally agreed that a modern budget system should be able to meet three main requirements: first, to **ensure control over expenditures** so that they are consistent with the budget law; second, to **stabilize the economy** through time by timely and efficient adjustment mechanisms for the fiscal aggregates; and third, to promote allocative and technical **efficiency in service delivery** through procedures that provide incentives for greater productivity. Typically, budget systems have evolved by progressively assuming, and placing different emphasis on, these three requirements. However, the process has been an evolutionary one, rather than one characterized by discrete jumps.

One can characterize budget systems as moving through distinct stages. Traditionally, the most basic systems focus on the first requirement—ensuring compliance with the annual budget law. This has been manifested in detailed line-item budgeting. While meeting basic compliance requirements, traditional budget systems usually then have modified their procedures and controls to accommodate the government's broad stabilization objectives and its need to adjust fiscal aggregates. This usually involved incorporating a top-down approach to ensure that fiscal policy can be harmonized with monetary policy. More specifically, this has been accomplished by introducing procedures so that the government has the means to plan, control, and monitor spending effectively and to be able to adjust fiscal aggregates to meet fiscal targets. Increasingly, these targets have been set in a multi year framework. After budget systems are capable of handling compliance and stabilization requirements, typically increasing emphasis has been placed on the third requirement, to ensure efficiency and effectiveness in the use of government resources. It is this last requirement, putting in place mechanisms to ensure performance-oriented budget management, that has progressively become the focus for OECD budget managers over the last two decades.

- *General recognition of the need for reform*

In attempting to move to institutionally advanced OECD levels of budget management, middle-income countries typically find themselves facing common problems. Their past attempts to ensure that budgetary processes would deliver a satisfactory aggregate fiscal outcome in support of macroeconomic stabilization now have revealed certain limitations. Even when care was taken to incorporate some degree of budget flexibility, typically the budget systems were left with a complex set of restrictions. These have been increasingly recognized as diminishing the allocative and operational efficiency of budget execution, normally with budget managers operating with limited responsibility for results.

Accordingly, there is growing acceptance that the next stage of reform is to provide greater inducement for managers to focus on possible improvements in allocative and operational efficiency at the program delivery level. However, before this stage can be reached, there must be a strong enough consensus—a critical mass of reform impetus—to enable a shift in the budget management model.

Usually, this consensus has been reached from two separate directions. First, the limitations of traditional compliance-oriented budget systems became more apparent. Second, with the increased use of more flexible budget management procedures, there was increased realization that stabilization and efficiency objectives were not necessarily competing, but could be complementary. As a result, traditional budget systems, based on short-term and detailed control of inputs, were increasingly questioned as a tool for promoting public sector performance, which by definition should focus on the outputs or the impact of these inputs. Accordingly, the increased suspicion that fiscal stabilization objectives were being achieved at the cost of performance, led many OECD countries to modify their budgets into performance management instruments and not just instruments of macro control.

When introducing a performance budget management model, with associated increased managerial freedom, it became evident that greater managerial flexibility could be viewed not only as a tool to improve efficiency but also to achieve the expenditure targets that had been set. Typically, managers of individual programs are found to be in the best position to decide on the most appropriate mix of inputs to be used for executing their programs. By providing them greater managerial freedom, managers could be assisted in achieving tighter budgetary limits—that is, improved efficiency in resource use could support stabilization targets.⁸

⁸ An OECD study found that greater managerial flexibility was associated with a positive aggregate fiscal outcome. That allowing managers greater freedom resulted in less emphasis placed on aggregate spending caps and increased the success of spending cutting exercises. See Strauch, (2000).

- *The reform strategy is a major part of government's overall policy*

Once the need for reform was recognized and accepted, a common approach is that it became part of the government's fiscal strategy, and a central element of government policy. The reform initiative was "owned" and supported by all ministers, not just the ministry of finance (MOF) or the budget office. In this way, it formed a critical element of management strategy for all budget institutions. All public sector managers had to assume responsibility for its implementation, and this could not be left to those managing the agencies' budget or its accounting system. This high-level commitment facilitated the required changes in administrative procedures and the willingness of central agencies to devolve budget management.

- *Assurance that adequate levels of fiscal control exist*

Before advancing down the road of a more flexible, more decentralized, budget model, all countries had reached adequate levels of control to ensure compliance and stabilization objectives. It was recognized that each of the three tracks—providing flexibility to budget managers, greater certainty in budget funding, and increasing pressure to perform—is essential. All three needed to be pursued to ensure the overall success of the reform process. In particular, increasing flexibility for spending agencies **without** pressure for performance improvement—i.e., making the managers manage—could increase rather than reduce inefficient use of budget funds. Similarly, provision of a more certain operating environment without increased pressure on agencies to deliver results could reduce aggregate fiscal control without generating improved program outcomes. It was, therefore, essential to proceed down these three tracks in a highly coordinated manner.

- *The need to "engineer" budget reforms*

Even within OECD countries, reform programs had to be engineered—a reform plan formulated, an implementation strategy agreed, and implementation managed to achieve the objectives and sustain the reform initiative. Additionally, the reform program had to be "sold" to the main stakeholders in the budget system. But perhaps more important, a reform team had to be identified and empowered to carry out the reform. It is this aspect of the reform process—the exercise in change management—which is the focus of this paper. That is, it addresses the question of how to engineer the shift from one budget management model to the other—literally introducing a shift within government from a compliance to performance culture.

IV. ELEMENTS OF A REFORM STRATEGY

Recognizing that OECD countries made this change in evolutionary and not discrete manner, and is a continuing effort, serves to emphasize the change process. By doing so, attention is productively directed to an examination of the implementation strategy and the mechanics of

implementation—i.e., managing the reform process as a whole, rather than concentrating on individual reform elements.⁹

One can interpret this most important aspect of the reform experience in terms of change management methodology.¹⁰ The latter emphasizes the need to address crucial components for successful institutional change that need to be followed in a logical sequence. One of the most widely known of the prescriptions for the successful change management is shown in Box 2. While this literature is derived from the private sector, and the experience of transforming large corporations, there are obvious parallels with attempts to reform the government's budget management system.

Box 2. The Stages in the Process of Creating Major Institutional Change

- Recognize a sense of urgency to make a change
- Develop a powerful enough coalition to support the change
- Identify a champion of change, who creates and communicates a common vision
- Empower and give resources to others to implement this vision
- Plan for early successes (“easy wins”) for positive demonstration effects
- Build on these early successes to sustain reform momentum
- Institutionalize the changes so they become a part of the organization's culture

Source: Adapted from Kotter, (1995).

Certainly, from the experience of government modernization programs in emerging market countries we can conclude that getting agreement from top decision makers that the budget system needs to be made more flexible may not be such a problem. That is, there is already a

⁹ G. Scott, in his analysis of PEM reforms in New Zealand, emphasized some important elements of this change management process, see Scott (1996, Chapter X).

¹⁰ Kotter (1996).

sense of urgency. Similarly, designing the organizational and procedural changes required is not so difficult. The “vision” is to adopt OECD budget systems. However, the real constraint is the human element in implementing institutional change. Generally, not enough attention is paid to the agents of change—identifying them, offering them incentives to undertake reforms, and removing the constraints they face in sustaining these reforms.

It can be argued that when engineering successful budget system reform at least three elements should be addressed:

- *Identifying agents of change*

Who are the champions of reform? Who is going to recognize the need for reform, design the reform, and monitor and implement the reform?

- *Assessing and assuring the adequacy of the means at their disposal*

How, and by what means, is reform to be carried out? What is the capacity to carry forward reform—is this adequate or does it require administrative restructuring, changes in procedures, and the skills available?

- *Restructuring the incentives to undertake and sustain reform*

Why, and for what purpose, will reforms benefit the individual rather than the system as a whole? Will individuals be compensated for the costs of the effort involved? Once reform incentives are established, how are they to be maintained and protected?

Some answers to these questions are attempted in the remainder of the paper.

V. THE AGENTS OF CHANGE

In a traditional highly centralized budget system, there is a presumption that changes are derived top down from the MOF, and most specifically, the budget office. This is not necessarily the case when introducing the new devolved budget management model. Typically, any relaxation of centralized controls is likely to meet the resistance of the central budget office, which should be the key agent of change. This resistance arises from a number of sources.

First, there is the fear of the unknown. Why adopt different approaches when the present ones have not broken down and appear to be delivering at least the bottom line fiscal result? How to convince the budget office of the need for a new budget management model which moves away from compliance and stabilization objectives and begins to emphasize efficiency, and effectiveness in resource use? Obviously, they will not be easily convinced unless they already have in place a management framework that assures basic compliance with the law, and allows sufficient certainty in the fiscal outcome, minimizing short-run disruptions to spending plans that may be needed to ensure fiscal stability.

Second, this conservatism is often reinforced by a concern that relaxing central controls, and giving budget program managers greater personal freedom, will result in more waste and corruption. This concern arises because waste is “invisible” in the present system. Traditional budget systems focus more on the correct use of inputs but not the possible waste generated in the outputs. Since control is on total inputs and not their composition, there is concern that given the present information system, allowing freedom in the composition of inputs will subvert this macro control. In all systems it is important to recognize that where line agency accounting and internal control systems are rudimentary and poor, corruption may increase. It follows that there should be a major program to upgrade agency financial management skills to some basic level to offer the budget office assurances about agency fiscal responsibility.

Third, there is often a natural reluctance to give up the power that goes with centralized control. Change is not only threatening, but it may also mean a loss of pecuniary or other benefits that follow from authorizing the release of detailed line items to spending agencies. As a consequence, the central budget office that should be the leader of reform becomes its chief impediment. How to restructure incentives to move the MOF’s budget office toward a new role? Only by consistent pressure from government and by recognizing that budget reform is a reform of the whole system and not just the MOF.

Fourth, it is not often recognized that the MOF generally has limited capacity for change management. In private sector companies change management is an activity that receives much top-level attention, and tends to be heavily funded. In the public sector it typically has suffered from benign neglect. Often there is a need to inject new, or build up, such capacity within government. Indeed, perhaps in the move to the new decentralized budget management model, the leaders of reform are to be found in the program agencies and not the MOF.

Moreover, the management constraint does not merely hinder the successful implementation of the reform process. The new budget model being introduced implies that public officials will cease being administrators and assume a management role akin to that in the private sector.¹¹ Unfortunately, a centralized compliance-oriented budget management system does not foster such management capacity. This capacity is often difficult to find in the MOF and is unlikely to exist in the line agencies either. These officials typically have spent most of their working lives in a compliance-oriented environment with a “command and control” management culture. Their reflex responses are to manipulate detailed external control systems to protect their programs from the cash-rationing operations of the MOF. Often they see their role as administrators, distributing limited cash to keep basic services functioning. This role does not recognize the value of good agency financial management, nor does it foster the acceptance of increased managerial responsibility.

¹¹ For a discussion of the importance of the management capacity and ethic in this budget management model, see Schick (1998, p. 130 ff).

How to build management capacity in a compliance-oriented traditional budget system? There is no easy answer to this question. However, experience suggests that a “big bang” approach is not possible. An interesting case is the experience of Bolivia, where in 1988 the government developed a program which recruited and provided a limited number of middle-level managers in the belief that manning a few “key posts” in each agency would considerably enhance performance. A total of 653 key posts were originally planned but, by June 1993, only 69 had been filled. The strategy of sprinkling a small amount of managerial talent across a large number of agencies evidently had little impact, and a new approach was tried. From 1992, the government adopted a broader civil service reform with a longer time frame, where around 2,500 targeted posts would be incorporated into a newly formed Civil Service Program. The new strategy was to achieve a critical managerial mass within selected central administration agencies, and to progressively expand the number of agencies in the program.

The case of Bolivia, as well as the experience of other middle-income countries introducing such reforms, suggests that the answer to this management constraint is twofold. First, it must be recognized that building this capacity will take time, and needs to be developed in stages. Second, this phased approach should be an integral part of the reform’s design. The latter is evident in one strategy which has been used in some middle-income countries—the adoption of resource agreements. The approach used in Thailand is summarized in Box 3. This approach, discussed more fully below, makes agency access to more managerial autonomy conditional on improved agency financial management. It is recognized that these systems, and the managerial capacity to operate them, if functioning properly, will be important assurances of the data quality and reliability of controls in the new devolved budget system. It is a way of minimizing the risk of misuse or abuse of managerial authority, while recognizing that agency capacity building will take time.

VI. THE MEANS TO MANAGE THE REFORM PROCESS

While the resources required for successful reform are usually assumed adequate for the task, experience suggests this is usually not the case. The experience of many middle-income countries—and even more the developing countries—is one of efforts to improve budget systems being stalled prematurely and being overtaken by changing external events. In part this has been caused by failures in the management of the change process, and in part by inadequate resources to carry out the reform. Are there lessons to be learned about the change management strategies that work?

Some generalizations, albeit subject to the qualification of exceptions, can be offered:

- *Emphasize objectives*

The cultural shift from a compliance-oriented to a performance-oriented budget management model essentially involves the move from focusing on inputs, and how they are employed, to focusing on outputs and how they fulfill the original budget objectives. This is a move away

from traditional administrative procedures to a more modern management orientation, focused on meeting clear objectives. Not surprisingly then, a key to a successful transition from one budget management model to the other is to focus on objectives. Those involved in the path-breaking public sector reform processes in New Zealand and Australia stressed this aspect of reform.¹²

Box 3. Thailand: Line Agencies Reform Contract

Main elements of the approach:

- Identify reform-oriented line agencies
- Offer them a “contract” or resource agreement
 - i. Reduced external control by Bureau of the Budget
 - ii. In exchange for demonstrated improvements in agency financial management
- The agency must demonstrate the achievement of “hurdle standards” in seven areas:
 - i. Budget planning
 - ii. Output costing
 - iii. Procurement management
 - iv. Budget/funds control
 - v. Financial and performance reporting
 - vi. Asset management
 - vii. Internal audit

Source: Dixon, (2001)

¹² For example, the 1989 New Zealand Public Finance Act, which introduced major reforms in fiscal management, developed a set of principles of financial management which began with the clarification of strategic and operational objectives.

- *Keeping participants focused on objectives*

Publicizing these objectives is one approach to create incentives and put pressure on participants to meet these objectives, as well as a way of enforcing efforts to hold them accountable for achieving these objectives. The United Kingdom's "Citizen's Charter" represents such a device, which publicly commits public entities to meet specific performance standards and identifies the means of redress when they fail to do so. In the United States, the National Performance Review during 1992–2000 also placed heavy emphasis on measuring and publishing results.

- *Evaluation of performance as a tool to enforce performance*

To be effective in helping meet objectives there must be a feedback mechanism to continuously improve the means to attain the objectives. At the same time, these mechanisms must be cost effective, and avoid excessive transactions costs, as well as minimize the risks in their application, in deriving biased, inaccurate, or inconclusive results.

- *Rewarding good performance and sanctioning poor performance*

The reform leadership must ensure a clear link between performance and rewards. Establishing clear performance accountability involves first a threshold level of basic financial and personnel management systems to be in place to report on performance, and second, a performance-oriented incentive framework linking rewards to performance.

Middle-income countries are typically handicapped in following the above strategy. In a traditional type of budget system, there is little emphasis placed on performance. With the budget focused on inputs, with detailed line-item controls on expenditures, agencies focus on obtaining spending approvals and utilizing them within the year. There is little attention paid to nonfinancial performance, and few sanctions on agencies for poor performance (and little reward for good performance). Management in line agencies, therefore, have not been used to subjecting new policy proposals to critical analysis. Nor have they been used to managing expenditure to achieve a budgeted outcome because this function was tightly controlled by the center. Consequently, they have not been compelled to develop an information system geared to supporting this objective. There is a need, therefore, not only to develop such evaluation skills in agency management, but to establish a supporting information system based on indicators of output and performance.

- *The need to upgrade basic management tools to provide adequate, relevant, and timely information*

Three aspects of this upgrading are worth noting:

Restructure the accounting system

The typical government accounting system, even if conceptually well defined and internally consistent, is a cash based one. The emphasis is on matching approved items of spending with actual cash outlays, the last stage of spending. This may be adequate for the compliance and stabilization objectives of the MOF at the center, but less relevant for the management purposes of budget managers in government departments. A precondition for moving to the next stage of budget system development is a need to upgrade the accounting system, towards an accrual-based system.

Greater application of IT

Against the background of the ever-growing volume and complexity of government financial operations, the critical importance to the fiscal managers of timely management information reports in a usable form needs little emphasis. Improved classification systems to identify programs, so that costs can be allocated to individual activities, to be compared with the outputs of these activities, has obvious management relevance. Tailoring such reports to management needs through a computerized financial information system has been a general PEM reform undertaken in various parts of the world. However, often the effort required has been difficult to sustain.¹³

Strengthening internal control systems

Before attempting to give agencies wider responsibilities in resource allocation, it is essential to ensure they are operating within an effective financial management framework. Good internal control is an important feature of this framework.¹⁴ Without satisfactory controls, management may not detect serious errors and irregularities, and the work of the central overseeing agencies, as well as external audit, becomes more difficult. Typically, control problems tend to cluster around control over the payroll and procurement procedures—which usually cover a large part of an agencies' expenditures. In strengthening and in ensuring quality control on internal financial management, internal audit has been seen as making a substantial contribution. The management effort required to upgrade these systems should not be underestimated. Similarly, the substantial information requirements to support internal control, and ways of ensuring its relevance, timeliness, and objectivity, cannot be ignored.

¹³ Early efforts to introduce state of the art systems in Bolivia's Financial Administration and Control System (SAFCO), and Venezuela's integrated FMIS during the late 1980s and early 1990s stalled. On the other hand, Ecuador, in its Modernization of the State reforms, began with more modest "bridging systems" that were developed in a few months in consultation with the end users, and were found effective.

¹⁴ See Diamond (2002b).

- *A top-down reform process may rapidly run into diminishing returns*

From the perspective of traditional budget management, the attempt to install a “bottom-up system” from the top down does involve a fundamental contradiction. The greater the success in decentralizing decision making, the weaker will be the perceived budget office’s leverage over agencies. With decentralization, and necessary greater managerial freedom, the previous approach of central control over detailed items of expenditure, without adopting traditional “command and control” procedures, may weaken the center’s effective control over the budget, and will most likely work against efficiency in resource allocation. The Budget Office must hence adapt its work practices and build up the information systems required for this new environment—and may encounter its own internal resistance to making such fundamental changes.¹⁵

Therefore, in terms of engineering these reforms, there may be conflicts involved in a top-down approach in directing managerial improvement from the center and achieving a consensus for reform. It has already been noted that, although necessary, it may not be reasonable to expect the central budget office to take the lead, and increase its capacity to assist others in implementing the reforms. If it tries to do this too aggressively, will it smother managerial initiative and encourage the old compliance mentality? Will a greater devolution of decision making be perceived in the central Budget Office’s interest, both in the narrow view of attaining its compliance and stabilization objectives, or more generally in reducing its overall influence over the budget process? There are costs as well as benefits in moving away from traditional budgeting methods—will the principal agents of change see a net gain to them in advancing this process? It is this last aspect, that of restructuring incentives to support reform, that comes out clearly as a crucial factor for success in countering the diminishing returns that may beset reform efforts.

VII. RESTRUCTURING INCENTIVES TO SUPPORT REFORM

The reform program cannot ignore the interests of stakeholders—particularly the key players, such as the central budget office and the targeted agencies. If the budget office cannot see that the reform process will safeguard its basic controls over the budgetary process, it is unlikely that office will be a strong ally of the reform. If the systems being created by the reform process do not provide agency-specific management tools desired by targeted line agencies, it is unlikely that those systems will yield the desired impact. These may also need to enlist worker support by involving them in the design and implementation, providing performance-linked institutional rewards, and introducing job transition assistance for retrenchment or retraining.

An approach that has been followed by some middle-income countries seems to address, at least partly, some of these issues (see Box 4). It is an approach that has been managed

¹⁵ This is discussed more fully in Schick (1997).

centrally, typically by the budget office, and it is described in a rather stylized fashion as a two-fold approach:

(i) applying pressure from above

- The MOF encourages agencies to undertake in-depth evaluations (possibly contracted out) of activities which it believes might warrant reconfiguration of resourcing to improve performance. These evaluations could be an input to the preparation of a MTEF.
- The MOF might also institute an “efficiency dividend” policy, whereby agencies will be required to find savings in their baseline budgets of an agreed percentage each year.
- Over time, as improved accounting for assets allows, a capital charge could also be introduced to ensure better asset management at the agency level.

Much of this effort is predicated on the MOF obtaining better information on agency performance. However, by itself performance information provided to central agencies is a fairly ineffective mechanism for ensuring that agencies actually use their new financial freedoms to enhance program outcomes rather than bureaucratic or personal goals. The center may set the new framework for budget management, and put in mechanisms so that if agency management fails they will be removed—but ultimately success depends on capacity of agency management to adapt to new outside pressures. The latter comes from within an agency itself, rather than from the central agencies. This is through effective leadership of the agency, clear frameworks of operation and responsibility, effective management information systems, and proactive central coordinating divisions in the areas of agency accounting and budgeting. Hence the second approach:

(ii) increasing capacity from below

The central budget office, as the agency responsible for budget management, adopts a proactive role in the development of good management in the spending agencies to which it provides budget funding. This is a key element in the budget reform model based on devolution of financial freedoms and a more certain operating environment. This takes the budget office out of its traditional detailed control mode toward a more managerial approach. Typically, some of the main elements are:

- The budget office highlights and “sells” improved management in spending agencies as a precondition of the budget reform process.
- The budget office develops competencies in the evaluation of internal resource allocation processes and structures in spending agencies; these should focus particularly on the ability of a spending agency to identify cost ineffective aspects of its activities and to reassign resources away from such areas.

- A checklist is developed within the budget office of the attributes of management systems in spending agencies which are conducive to allocative flexibility.
- The budget office then works with spending agencies in the application of these competencies to agency operations, with the ultimate goal of the agency both undertaking internal reallocation and identifying savings options in response to external budget management requirements.
- The budget office also initiates a review of performance indicators for each major department. This should begin with the enumeration of departmental activities and the objectives being pursued by each. Performance indicators already available in departments should then be matched to these objectives and gaps in the existing range of performance indicators identified. Assistance should then be sought from sectoral experts in the definition and collection of new performance indicators to fill these gaps, before the complete system of indicators is institutionalized.

Box 4. Formal Performance Agreements Between Central Authorities and Agencies in Latin America and the Caribbean¹

Benefits derived by agencies:

- Easier to hire key human resources.
- Enhanced managerial autonomy.
- Reliable cash flow relative to budget.
- Performance-linked institutional rewards.
- TA to improve management processes.

Accountability requirements:

- Minimum reporting standards in financial and personnel management systems.
- A financial restructuring plan or institutional strengthening agreement with detailed implementation plan and deliverables.
- Agreed performance targets and associated reporting requirements.

¹Based on programs of Bolivia, Ecuador, Jamaica, and Nicaragua, see Reid (1998).

VIII. PROVIDING AN ENABLING ENVIRONMENT

Unlike a policy change, an institutional reform, such as that involved in budget system reform, typically has no political constituency. In the general population no one is pressing for this reform because there is a perception of powerlessness in bringing about enhanced expenditure benefits or improved efficiency in service delivery. Part of the answer of sustaining reforms revolves around how to generate the pressure for reform in society as a whole. What are the elements of such an enabling environment?

- *An adequate level of fiscal stability*

Crisis can trigger the perception of the need for reform; at the same time, it can deflect from it. While the debate continues, we note that OECD countries carried out a major fiscal consolidation concurrently with introducing major fiscal reforms. The pressure for budget reform largely arose from the rapid growth in the public sector in the 1970s and early 1980s, raising questions as to its affordability and whether it was providing value for money. The growth in public spending had been so sharp that there were doubts as to its sustainability and there was a recognized need to find reductions in some sectors to satisfy new emerging demands. General concerns that taxation levels were too high, and the public sector was crowding out the private sector also added to this pressure for change. The consequence was a substantial fiscal consolidation, reducing budget deficits and stabilizing debt levels, alongside the introduction of fundamental budget system reforms.¹⁶

While fiscal crisis may have been a barrier to reform, it could also prove to be an opportunity to introduce fundamental reforms. It has been argued that in crisis conditions changes may be more easily accepted and more quickly implemented. Often the experience in transition economies was that, when the degree of fiscal stress was severe, the initial reaction of public officials was to muddle through, adopting short-term crisis management solutions that often were hostile to longer-term reform. Undoubtedly, the degree of crisis is important—too much can be disruptive and counterproductive for reform.¹⁷

Some qualifications are perhaps in order. First, perhaps more important than the degree of fiscal stress is the capacity of the budget system to adapt to it. If reliable mechanisms are in place, then fiscal stress is probably a secondary factor. Second, if fiscal stress is not so destabilizing as to allow some political and administrative stability, then its negative impact can be expected to be much diminished. In this scenario there will be continuity in

¹⁶ See OECD (1996).

¹⁷ For a discussion of the case of Russia, see Diamond (2002a).

management, to focus on solutions to the immediate problem, and at the same time put in place more substantive changes to address the root of the problem.

Third, much depends on the reform strategy adopted. An approach which lacks focus and priorities is most liable to fall prey to short-run crisis management. At the same time, an approach that is too ambitious and costly will also be doomed. As suggested, performance-oriented public sector modernization confronts immediate upfront costs, and in all likelihood requires substantial infusion of scarce managerial talent to be effective. Recognizing this, reform should be designed in a way that phases in the cost increases over a long enough period of time so the government can meet the increased fiscal costs, that also allows sufficient time to reap the benefits of improved efficiency, and so does not jeopardize overall macro fiscal policy stance. A gradualist approach that incorporates agencies serially over a sustained period will be required because professional human resources required are in short supply. Also, such an approach enables learning from mistakes. Moreover, the serial approach, by allowing reform to start with the most promising agencies, enhances the chances of demonstrating visible results early on, and provides momentum for reform.

- *To be sustainable, reform requires a compatible legal and regulatory framework*

A broad regulatory framework is required that should establish the broad parameters for ensuring adequate budgetary controls and granting appropriate managerial autonomy. The latter should be conditional on the agency management providing adequate accountability for those public resources under its stewardship.

This usually involves a streamlining of existing budget procedures and associated financial regulations. In centralized compliance-oriented systems, there is usually an accumulation of layered controls that have arisen over the years. A set of controls is introduced to remedy some abuse. These are then circumvented, leading to the institution of additional controls to plug the gaps. The layers of controls further encourage managers to try and circumvent them to get things done, leading to a vicious cycle. There is a need to rid the system of these redundant and counterproductive controls.

There has also been recognition of the need to set the new regulatory framework in the wider context of a framework fiscal law. As is evident, a number of new fiscal frameworks are legally based, to force governments to commit credibly and assuage governance concerns. Another possible important aspect of adopting the new fiscal framework is its demonstration effect. In many countries there have been repeated efforts at budget system reform or reform initiatives in the budget sphere. There is a natural tendency, therefore, for bureaucrats who have seen “reforms” come and go to be cynical, and adopt a “wait and see” strategy. Adopting a new wide sweeping regulatory framework thus has the added advantage of overcoming the bureaucracy’s “business as usual” attitude. The basic idea is to create rules and procedures that impose costs on governments and bureaucrats for deviating from fiscal responsibility.

The pioneer in this field was New Zealand through the Fiscal Responsibility Act of 1994. The latter laid down principles of responsible fiscal management, as a framework for defining necessary fiscal procedures, fiscal targets, and fiscal reporting to ensure these principles were upheld. The need for greater transparency in fiscal management was an overarching objective of this legal framework. Not only are governments required to specify and adopt agreed fiscal targets, but they are required to explain the policies underlying their attainment and, when deviating from this policy commitment, they are required to explain not only its rationale but also planned future corrective action. The Australian Charter of Budget Honesty and the United Kingdom's Code for Fiscal Stability have adopted this approach, albeit in different forms. Notably, Brazil has recently adopted its own Fiscal Responsibility Law.

- *Increased emphasis on fiscal transparency*

Transparency in government operations is increasingly regarded as an important precondition for good governance and sustainable economic growth—but, for the emerging economies, it is also an essential aspect of sustaining confidence in government and, through this, support for the democratic system and economic advancement. The latter has become particularly acute with the exposure of fiscal policies to international financial markets because of the increasing use of market financing of deficits. Such exposure has required many governments to modify past policies and so has assisted in achieving fiscal discipline and improved resource allocation.¹⁸ It is also an essential ingredient in establishing the new budget management model.

Promoting greater transparency is a means to bolster reform. Restructuring incentives by concentrating on the stakeholders within the budget system is unlikely to be enough—there is also the need for measures to activate the interests of clients to support the reform. It has been recognized that clients need to be empowered, and client feedback strengthened and made more transparent. The latter is evidenced in two main trends: improving the type of performance information, and strengthening feedback channels.

- *Empowering clients*

One technique to accomplish this is by widely publicizing performance standards that should be expected from particular public agencies, and by spelling out the specific steps the public can take to force agencies to meet these standards. As indicated, the UK Citizen's Charter, attempted to do this at an aggregate level, but such initiatives are possible at a program level.

¹⁸ "Global commercial liberalization and the free flow of capital are exerting new pressures on systems of public governance. Recent experience shows starkly that the quality of public institutions and the trust in which they are held by economic players can have very demonstrable effects on the behavior of these markets. Public sector governance systems that induce loss of market trust impose costs not only directly on their domestic economies, but more generally as they reduce global growth rates below potential." (1999, Chapter 16, p. 343).

- *Supplementing quantitative performance indicators with indicators of quality*

The importance of performance indicators has long been recognized in reforms associated with performance budgeting, as evidenced by the ever-expanding literature on the subject. The increased requirement for performance data, and for improving performance measurement, as a way to improve resource allocation for government cannot be doubted. However, one can detect a new trend to obtain different types of performance data. Typically, performance data has been directed to the following questions: first, how well are services delivered? (efficiency concerns); and secondly, are planned objectives being met? (effectiveness). However, increasingly important has been a third type of question: are customers satisfied with the results? (a quality dimension).

In the United States, the Government Performance and Results Act (GPRA) was enacted in August 1993 to improve the public's confidence in government by holding agencies accountable for program results. Promoting a focus on results, improving the quality of services, and measuring customer/citizen satisfaction with government services were important elements of the Act. Improving the delivery of services by not only requiring that managers establish plans for meeting their goals/objectives but also providing feedback to managers regarding actual program results and quality (see Box 5).¹⁹

- *Strengthening consumer feedback*

Nowhere is this push to improve the efficiency and effectiveness of government service provision more noticeable than in the rapid adoption of IT in government, mirroring developments in the private sector. The spread of e-government has been increasingly documented.²⁰ In the United States, there has been a rapid expansion in Constituent Relationship Management technology (CRM, also known as Customer Relationship Management)—a class of software designed to provide governments with the ability to manage their constituent relationships. The idea is that constituents can contact their government via a variety of channels. Recorded contact information can be logged, analyzed, and then effectively employed in various business processes. The widespread use of e-government means that the analysis of consumer feedback data can be a powerful input to agency decision making. In this way, government's performance can be monitored for the quality of different types of contacts, showing where the government is doing well and where improvements are required. Constituent data can be analyzed so managers can segment their client groups in order to deliver more specifically tailored programs—and so improve the quality of service provision.

¹⁹ See Clinton and Gore (1994).

²⁰ For a commentary on some of the most recent developments, in this rapidly developing field, see the commentary and references contained in OECD (2001)

Box 5. The U.S. Government Performance and Results Act, 1993

The Act is an amendment to the Budget and Accounting Act of 1921, covering all agencies of the federal government (only excluding legislative and judicial branches and the CIA).

Important elements of the Act

- To improve citizen confidence in government by holding agencies accountable for program results.
- To encourage reform through a series of pilot projects focused on setting goals, measuring performance, and reporting progress against goals.
- To focus on results, improving the quality of services, and measuring customer/citizen satisfaction with government services.
- To enhance decision-making by disseminating information related to efficiency/effectiveness of federal programs.

GPRA requirements

- Established a system of interrelated plans and reports that were designed to provide the basis to link resources and results.
- Each agency has to produce a five-year strategic plan, which must be revised at least every three years.
- Agencies have to develop annual performance plans, establishing specific program goals, identify the resources required to meet those goals, and link this with the strategic plan.
- Agencies have to provide an annual performance report reviewing its success in achieving the previous year's performance goals, and from this perspective explain any deviations.
- Pilot projects introduced to allow some agencies more flexibility, to waive certain administrative requirements for their annual performance plan, but managers would be held accountable for achieving higher performance.
- Introduction of a two-year pilot project of performance budgeting in a few agencies, providing Congress with information on the direct relationship between proposed program spending and expected program results.

Evaluation

Since its enactment, the GPRA has been continuously analyzed and reviewed by stakeholders and independent bodies. It has been found that some agencies have made substantial progress and others have found it difficult to meet its basic requirements. Major problems encountered were the ability to generate reliable data, problems in developing measures for programs/activities spanning more than one agency, and in making the transition to performance budgeting. Notwithstanding these difficulties, basic support for the implementation of the GPRA continues.

IX. LESSONS LEARNED

Are there any lessons learned for successfully introducing and sustaining the move from one budget model to another?

- *First and foremost, the degree of required management skills should never be underestimated*

Who is going to manage the reform process? Who is going to manage the new budget system being introduced? The successful answering of these questions can make a key difference in emerging countries where there is no great depth of managerial expertise in government.

- *Proper sequencing of reforms*

Management capacities must be strengthened as a prerequisite to devolving management autonomy. The new devolved budget management model must rest on solid management foundations, especially at the agency level.

- *Begin modestly and do not attempt to be too ambitious*

In design, a gradualist rather than a “big bang” approach is advocated. In implementation, rather than attempting blanket coverage, a serial approach is preferred. Rather than opting for advanced technologies, making do with what is available and familiar may pay dividends, at least initially. There has been some relevant experience of public sector reforms that sought to install complex fully integrated financial management information systems (FMIS). These have often proved to be beyond immediate capacities and deflect from more fundamental managerial reform in developing more effective administrative procedures to be computerized.

- *Identifying the right management teams*

The inevitability of allowing some discretion for the management teams, coupled with practical limits in holding them fully accountable for all dimensions of their agency performance, implies some risk of misuse of this discretion. It is important that the change management team shares common objectives which are fully congruent with that of the government. The more fully the government can trust the management team, the more likely is the reform to achieve its objectives.

To find managerial leadership with common vision, technical competence, having authority to spearhead the reform, and being fully committed, seems daunting. But the fact is that such leadership has been possible to find in many countries, and offers living proof that in budget reform the human factor cannot be neglected.

- *The role of technical assistance*

There may also be some lessons to learn for Fiscal Affairs Department's delivery of TA. When advising countries that are considering the new generation of performance budgeting reforms, perhaps more attention needs to be paid to the change management capacity in the country. It may be necessary to develop a check list that will enable some assessment to be made of this capacity and hence the likelihood of success in delivering TA. The above discussion has highlighted some key dimensions, and possible relevant considerations for this risk assessment, which are reflected in Box 6. When contemplating such a fundamental institutional change implied in transiting from one budget system management model to another it would appear crucial to be able to answer such questions positively.

Box 6. A Possible Checklist in Assessing the Risks in TA Delivery

Are the agents of change well identified?

- How deep in the administration is the recognition of the need for change?
- Is this recognition at the government level, the level of the minister of finance or lower?
- How stable/established is the reform team?

Do the reformers have an adequate base to work with?

- Is there an adequate level of fiscal stability to ensure success rather than a diversion of energies?
- Is there sufficient political and administrative stability?
- Can the up-front costs of reform be borne by the government in the short term?
- Does the present system have basic levels of fiscal control and financial management to support reform?

Does the overall environment provide incentives to support reform?

- What is the general level of managerial capacity to implement reform?
- Is the regulatory framework adequate for reform, or does it need to be changed?
- What is the general perceptions of the level of governance in the country?
- How empowered are the consumers to demand better performance from government agencies?

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