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Reforming the Russian Budget System: A Move to More Devolved Budget Management?

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Abstract

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The Russian federal government has recently initiated a fundamental reform of its budget system, encompassing important policy, procedural, and institutional changes. This paper reviews this reform agenda with reference to the experience of industrial countries that over the past two to three decades have followed a similar reform path toward a more devolved budget management system. From this perspective, the importance of the strength of existing public expenditure management systems to accommodate increased devolution and the scope for employing decentralized agencies is explored. An assessment of the present Russian reform plans in light of this review reveals a number of concerns. First, the speed of the reforms contemplated appears overly ambitious when judged by the experience of other countries. Second, the preparedness of budget institutions is questionable. Third, change management capacity needs strengthening with a more carefully defined strategy. Last, in light of these concerns, it is argued that the scope and “big-bang” approach of the current reform plans may need reformulation into a more sequenced strategy with clearer reform priorities.

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I. RUSSIA'S LATEST BUDGET SYSTEM REFORM INITIATIVE

Budget reform in Russia progressed substantially with the passing of the 2001 Budget Code.² While it is possible to detect some features in the Code that reflect the system inherited from Soviet times, for the most part the passing of that law was a major step in moving Russia toward principles and practices underlying budget systems found in many industrial countries. However, it was recognized that the passing of this law was the beginning of the next phase of budget system reform rather than its final solution. Indeed, in a previous study an attempt was made to identify existing constraints on the full implementation of the Budget Code, and to suggest possible areas for further reform.³

In the past, an important constraint on reform was the degree of instability in the macroeconomic situation that adversely affected reform efforts. It has often been debated whether structural reforms are more easily accepted in times of fiscal crisis or are stalled by them. Certainly, the Russian experience in the 1990s was that the degree of fiscal instability was a barrier to institutional reform, tying up key decision-makers in “fire fighting” activities. The recent period of relative stability, engendered by rising oil prices,⁴ has provided a more accommodating environment to address one of the most pressing among identified reforms—the need to better align resources with budget commitments to make the budget more realistic. It was realized that to do so required a fundamental review of government operations to assess the size of core government activities that could be financed from the present tax base. Failure to address this fundamental issue had adverse effects on other improvements to the budget process. Without such a review of the structure of government operations, it would be too easy to revert to unrealistic budgeting in times of fiscal stress, and to the employment of disruptive ad hoc solutions during budget execution. In the past these not only reduced the transparency of the budget process, but also led to major inefficiencies in resource allocation that only compounded the difficulty in redressing other fundamental problems of fiscal management.

II. A THREE-PRONGED APPROACH TO BUDGET SYSTEM REFORM

The increasing recognition of the need for budget reforms has witnessed a systematic review of government operations since 2001. This work recently culminated in a major reform initiative introduced by the presidential decree of March 9, 2004, “On the System and Structure of Federal Executive Authorities,” and the Budget Process Reform Concept Paper for 2004–06, that was approved by the government by Resolution 249 of May 22, 2004 and

² For a description and assessment of this legislation, Diamond, 2002b.

³ See Diamond, 2003d.

⁴ An attempt to make this even more secure was the introduction of an Oil Stabilization Fund at the beginning of 2004, to create a buffer to finance possible downturns in oil prices.

endorsed by the President.⁵ Between them, they represent a most ambitious attempt to fundamentally restructure of the Russian federal government apparatus. This agenda has three main elements: budget policy reform, especially of intergovernmental fiscal relations; reform of the budget process, toward a more results-orientated form of budget management; and a complementary institutional reform, aimed at streamlining the government apparatus.

A. Budget Policy Reforms

A primary objective of these reforms is the intention to reassign many functional responsibilities among different levels of government. First, is a centralization of military registration and the draft, and a division of the police service into a federal service and municipal militia, with clearly differentiated authority in civil defense. Second, this centralization is countered by a strong emphasis on decentralizing spending assignments of a social nature from the federal to regional level: for example, children's allowances, disability and veterans benefits, schools, kindergartens, health centers financed by federal ministries, as well as secondary vocational training. There is a parallel move to concentrate spending authority for social support in the regions: from the federal level and away from local level, for the targeted housing subsidies, financial support of the schooling, subsidies to agricultural producers, and compulsory medical insurance contributions for nonworkers. Third, there is to be a push to monetize benefits for military and law enforcement staff, replacing noncash benefits for war veterans, cash supplement to pensions for federal government; and at the regional level, for benefits to labor veterans and the disabled. Fourth, there has been a move to open up government sector wages to market forces. This will be accomplished by a decentralization of the powers to regulate salaries in the government sector. The centrally determined uniform salary rate schedules, along with the central determination of "local coefficients" and local and regional cash supplements, are to be replaced with more flexible sectoral salary schedules and differentiated regulation of salaries for federal, regional, and local authorities' employees. Only time will reveal what proportion of this comprehensive reform agenda will be able to find political consensus, since there will be clearly defined winners and losers in all these policy moves.

B. Reform of the Budget Processes

Reforms in budget procedure are largely in the hands of the executive and hence potentially easier to implement. These reforms have been introduced with the Budget Process Reform Concept Paper for 2004–06, whose main principles were agreed in April 2004.⁶ This was followed by a May 22 resolution setting up a government commission for increasing the efficiency of government expenditures, under the chairmanship of the Deputy Prime Minister, A.D. Zhukov, to direct this reform. The declared objective of the reforms is on switching from a system of budget management focusing on costs to management by results.

⁵ See President Putin's May 26, 2004, address to the Federal Assembly.

⁶ Detailed recommendations on the various issues in the Concept Paper will be worked out by the Institute for Economies in Transition and the State Budget Reform project, funded by the European Union.

There are five main elements of this reform. First, is the reform of the budget classification and accounting. This will involve a move away from excessive detail in budget nomenclature to the approval of only the main items contained in the Budget Code. This will be consistent with a single Chart of Accounts (COA) for government institutions, closer to international approved standards that will allow a phased transition to accrual accounting. The main changes proposed in budget classification affect the functional classification where it is intended to reduce the current 27 categories to 11.⁷ Second, there is to be a clear differentiation between present and new policy commitments when preparing the budget. It has been recognized that 90–95 percent of commitments are already “locked-in” so the truly new programs only occupy 5–10 percent of the budget. In this way, there is a differentiated treatment between approval of a baseline budget and the approval of new policies. The latter, of course, will further lock-in the budget in the future. Third, there is the introduction of medium-term budget planning as part of the 2006 budget covering the period 2006–08. The reforms attempt a move away from an annual approach to budgeting toward the approval of an indicative rolling budget framework for three years, broken down by government departments. Fourth, there will be a streamlining of the budget process. Most notably, there will be the reduction in the number of readings for the budget from four to three.⁸ Another feature will be the replacing of the existing practice of approving the detailed budget classification by a separate federal law, by the law fixing only the main codes of the classification that would be mandatory for all budget levels.

However, perhaps the most ambitious element of this reform package is the introduction of program and performance budgeting methods. This has been introduced as a two-year “experiment,” where budget institutions have been invited to prepare and execute their budgets on a results-oriented basis for the 2005 and 2006 budgets. To induce participation a “prize” of Rub 300 million was offered to supplement participants’ budgets.⁹ Specifically, there will be a requirement for budget institutions to report on results, and mechanisms for monitoring efficiency in resource use. This implies that federal “earmarked programs,” for large investment, research, and structural projects, will be restructured to reflect efficiency objectives (and their number will be reduced). Departments will also introduce “targeted programs,” smaller in scale, focused on extension of services or projects, along agreed procedures that will emphasize objectives, indicators for these objectives, and measures of

⁷ The latter largely following Government Finance Statistics principles, see the IMF’s *Government Finance Statistics Manual, 2001*, Chapter 6. The approach will be to improve the lower levels of the functional classification and introduce a program structure. Unfortunately, the latter introduction will require amending the Budget Code.

⁸ The first reading will only discuss the broad parameters and the committed “old policy” budget; the second reading will discuss new policy; and the third reading will be a general review of the entire budget with detailed annexes of each main budget institution.

⁹ To date nine ministries have declared their interest and in October the ministry of finance selected five that will share the “prize,” reduced somewhat to Rub 180 million.

results. There will be a competitive allocation of budget resources between programs, as well as incentives (both financial and administrative) to ensure results are obtained. Budget institutions will be required to submit annual reports on the results of their main activities, with an assessment of the efficiency of spending by previously determined indicators, and with agreed powers and responsibilities of different management units for each activity. This approach will be phased in with the preparation of the 2005 and 2006 budgets.

C. Institutional Reform of Government

Along with these changes in budget procedures has gone an ambitious plan for streamlining budget institutions, and a change in their nature. In many ways this represents the most radical of the reform elements.

No one doubts that the Russian federal government sector required major pruning. A recent survey found some 40,700 budget institutions and the plans are to eventually reduce this number to around 1,500, within a three-tier system of ministries, services, and agencies indicated in Boxes 1 and 2 below. The number of top level institutions, *ministries* and their equivalent, has been reduced, and as a consequence the cabinet considerably downsized from 31 to 18. At the same time the number of subordinate bodies increased from 31 to 54, indicating more detailed specifications of functions. This institutional hierarchy has been reinforced by the new structure of responsibilities, with ministers proposing directors, and selecting and appointing the deputy directors of their subordinate units. A ministry will approve the budget and staffing, the business plan, and the consequent “performance indicators” for their subordinate units. *Services* are to be the enforcers and regulators of policies decided by ministries, to be funded almost entirely from the budget, without outside income sources. On the other hand, *agencies* are much more devolved entities. Although partially funded by the budget, they often provide services to the private sector, and have been given the right to charge fees for their services, that also may be outsourced. The new agencies and services have been encouraged to liquidate some smaller spending units and establish larger units by amalgamating smaller units. Alongside this institutional restructuring, there are other significant supporting measures such as civil service reform, and in particular pay reform based on this new division of labor within government.

This institutional restructuring is most evident in the ministry of finance (MoF), where the number of deputy ministers has been reduced from 12 to 2,¹⁰ reflecting a reduction in the number of departments from 28 to 11 this year, and then to 10 in 2005 when the Treasury becomes a Federal Service. The aim is to shrink the number of MoF staff from 1,712 to 1,370. It is clear that there will be an important change in status for the Treasury when it will become a Federal Service, exercising control and supervision functions but not involved in policy determination, nor in management of state property and provision of paid services (the latter is the role of an agency). There is a concern that in assuming this new status the

¹⁰ As reported in Kommersant, No. 86.

Treasury will lose some of its authority over other budget institutions, having always to channel its directives through the MoF. Also there is some concern over the degree of coordination with other functions of the MoF. For instance, the coordination of budget execution with budget policy, and the coordination of cash management with debt management may prove more difficult than in the past. To ensure continued fiscal discipline it will be essential to protect against these two possibilities.

Box 1. Key Features of the March 9, 2004 Presidential Decree on the Structure and Functions of the Russian Federal Government

- **Establishing out of the previous six types of budget institutions a three-level structure: ministries, federal services and federal agencies on two tiers**
(1)
- **Establishing five distinct functions for the federal government :**
(2)
 - Functions related to the adoption of regulatory legal acts: formulation of federal laws mandatory for enforcement by state authorities, local authorities, legal entities and individuals.
(2a)
 - Functions related to the control and supervision by state authorities, local authorities, legal entities and individuals, by issuing of licenses, permits for execution of specific activities; registration of documents, rights and assets.
(2b)
 - Functions related to the implementation of policies, as well as enforcement (“enabling functions”).
(2c)
 - Functions related to the management of state property, exercising owner’s authority on behalf of the state, including the shares in open joint stock companies which are in federal ownership.
(2d)
- Functions related to the provision of public services, which have “an exclusive public significance,” and which are offered to the general public on terms established by federal legislation.
(2e)
- **These functions are allocated to different institutions:**
 - **Federal ministries** will elaborate state policy and legal regulation of the acts of the President and government; not allowed to exercise control and supervisory functions, nor management of state property, but will act to control and coordinate the activities of federal services and agencies.
(3a-d)
 - **Federal service** acts as a federal executive authority exercising control and supervision functions but not in management of state property and provision of paid services.
(4)
 - **Federal agency**, acts as federal executive authority in provision of public services, the management of state property and enforcement functions (except for the control and supervisory functions).
(5)

Note: Paragraph numbers of the Decree appear in parentheses.

Box 2. The New Organizational Structure of Government

- **Ministries, services, and agencies to be divided between the President and the government**
- **Heads of federal executive authorities** administered by the President will be appointed and dismissed by the President, and similarly for those under the government as advised by the supervising federal minister. The President is also in charge of their mode of interaction with the executive authorities under the government.
(7)
- **Executive bodies to be managed by Boards** (“management bodies”).
(7)
- **Procedures for the appointment of heads and members of the Boards** of federal services and agencies shall be determined by the government, except as otherwise stipulated by a federal law.
- **A streamlining of government:** one deputy prime minister (8); 13 ministries abolished, and 11 state committees, services, and agencies abolished. Replaced with 6 ministries, 16 services and 20 agencies. The number of ministries reduced from 23 to 14.
(13)
- **The Federal Treasury** is accorded the status of a federal service with enforcement functions to the MoF related to ensuring implementation of the budget; the ministry of taxes to a Federal Tax Service, and the State Customs Committee to a Federal Customs Service.
(13) (14) (15)
- **Reallocating some functions and reorganizing** a number of state committees, federal services and agencies. (15)
- **Significantly the “power ministries” regarded as federal services** for national defense, national security, guarding the borders, crime patrol and public security.
- **A tight deadline for putting this institutional framework into effect:** reallocating the abolished federal authorities’ functions in one month; approve maximum staffing requirements in one month; proposals to restructure paycales within two months; proposals for all necessary amendments to existing legislation prepared in one month and executed in six months. (21)

Undoubtedly, the policy reforms involving the monetization of social benefits and other informal mandates is a major step toward a more rational budgetary system. Similarly, the efforts to tackle the thorny issue of intergovernmental fiscal relations—traditionally the Achilles heel of the Russian budget system—are extremely important. However, important as these policy changes are, as its title suggests this paper focuses on a review of the latter two aspects of budget reform—those specifically concerned with budget management issues. The latter appear an attempt to remodel the Russian federal government along OECD lines, and by doing so to increase the effectiveness of its operations through increasing their

transparency and hence ensuring greater accountability. While the direction of the reforms is not in doubt, what is unclear is the degree to which this and related reforms reflect an attempt to adopt the most progressive elements of OECD budget practices—a performance-based more devolved system of budget management. However, the indications suggest the ultimate agenda of these reforms is quite ambitious in this regard.

III. RECENT TRENDS IN OECD MEMBER COUNTRIES

Clearly, the Russian reform plans embrace some of the newer elements of OECD budget practice, often referred to as “results-based” or “performance” budgeting¹¹ that aims at forging a more direct link between the allocation of resources through the budget and performance in reaching the stated budgetary objectives. Although countries have taken different approaches to how they achieve this, there are some common elements that can be identified from OECD experience.

This reorientation has typically necessitated that countries make a number of fundamental changes in traditional budget management. A devolved management structure, with day-to-day management in the hands of the managers of more autonomous units, necessitates a move from ex ante control of resources, away from extensive central regulation and ex post inspection to ensure compliance, toward a system of continuous monitoring the attainment of objectives. The center no longer manages directly, but must facilitate the defining of objectives, assist devolved units in meeting these objectives, and evaluate results ex post to enforce accountability. These new management systems tend to have three main elements. First, they link budget negotiations more closely to the spending units’ objectives and performance measurement, and in doing so they assist developing the framework in which performance is given greater emphasis. Second, they focus the work of central units on strategic priorities and away from intervention in line units’ day-to-day operations, deciding the division of labor between them. Third, they develop appropriate measurement and reporting arrangements to ensure full accountability focused on results. While most of these elements can be detected in the Russian budget reform concept paper, one other important element is not so visible. A key feature of the new performance budgeting approach is the recognition that, if performance is to matter, the objectives of the budget management system must be integrated with overall accountability so that good budgetary performance is rewarded while a poor one is penalized.

Introducing such reforms has usually necessitated parallel changes in budget institutions. In the OECD member countries there has been a clear trend to differentiate policy from the delivery of that policy, and to distinguish different types of service, particularly those that are governmental in nature and those that have market features. Certainly the new three-tier

¹¹ “The widely used international model of ‘performance budgeting’ will constitute the nucleus of the new organization of the budget process within the frame of medium-term financial planning.” (Concept Paper p. 3).

institutional structure for the Russian federal government, based on clearly differentiated functions (see Box 1), could provide the basis for a devolved budget management model. In reviewing this distinction between ministries, services and agencies, two points could be made. First, it should be noted that although the performance approach is often characterized as separating policy and delivery, typically in practice this is not a strict separation. While separation is sometimes necessary to justify managerial autonomy of units, the center must also recognize that these devolved units are typically the most aware of practical issues and the effects of their actions, and hence deserve a say in policy. Second, the OECD trend to devolved management has taken many institutional forms with varying degrees of autonomy found suitable to different types of functions.

Organizationally the trend to devolved government can be described as a process on a continuum, characterized in Box 3 as the Four Ds: deconcentration, decentralization, delegation, and devolution. The first two Ds—deconcentration and decentralization—are institutional arrangements associated with traditional vertically functioning ministries, and were already features of the Russian system. The second two Ds—delegation and devolution—are more creatures of the new performance budgeting approach that has led to the creation of a wide range of public bodies that form part of the government but have been given varying degrees of managerial autonomy, or independence, from ministries. It is clear from this description that moving from delegation to devolution can be viewed as one of degree, and as simply a progression in managerial or operational autonomy. While delegated and devolved organizations have a longer history in some countries, clearly the latter two decentralization trends—of delegation and devolution—noticeably accelerated in the 1980s and 1990s in OECD member countries with the increasing adoption of performance budgeting techniques.

While the degree of autonomy aimed for by the new Russian institutional reforms is as yet unclear, internationally there are many models to choose from, all with the common objective of providing greater management flexibility. These bodies typically function under quasi-contractual or full contractual relationships with the ministries, especially those associated with service delivery.¹² Again, the degree of autonomy tends to vary between countries, as do the type of functions they carry out, and in nearly all they undertake an important share of government spending.¹³

¹² This excludes state-owned enterprises, bodies resulting from administrative decentralization, and constitutional bodies (such as courts, audit bodies, etc).

¹³ Partial data available suggest their share in public expenditure and their share of civil servants employed can be over 50 percent, and in some countries above 75 percent. For example the United Kingdom has 131 executive agencies that employ over three quarters of the civil service; in Spain 51 percent of the budget is spent by government-related entities; the New Zealand Crown entities employ around 80 percent of state sector employees; in Germany 22 percent of public employees work in federal agencies; in the Netherlands in 2002 30 percent of the civil service worked in agencies, a percentage which continues to increase steadily. (OECD, 2003, p. 8).

Box 3. The Four “Ds”: Progressive Models of Decentralized Management— Deconcentration, Decentralization, Delegation, Devolution*

- ***Deconcentration***

A first move away from centralized decision-making, deconcentration represents no reallocation of administrative authority from the center to the operating agencies. While maintaining centralized decision-making, decentralized implementation is allowed to give local managers some flexibility in administering centrally determined policies which are difficult to implement centrally. Unit managers, however, are not managers in the true sense but administrators of centrally determined decisions.

- ***Decentralization***

A further move from centralized decision-making represents a full reallocation of implementation from the central levels to the line agencies, again with no major reallocation of decision-making authority. In this arrangement agency managers remain administrators, but with greater freedom to administer central policies to fit the day-to-day circumstances encountered. In terms of the budget, the hegemony of the central ministry remains, and it maintains the right of reallocating resources between units, and their budget is subject to the usual annual budget review process.

- ***Delegation***

This arrangement represents a significant step over decentralization. Organizations although legally part of ministry/government are given greater autonomy and independence in decision-making. Central supervision is at arm's length, and most likely through an intervening supervisory board or single person authority with significant management responsibility, even though the ministry retains ultimate power over the board. For arm's length management a quasi-contractual form of budgeting is put in place, with targets set by the reporting ministry in consultation with the agency head. This feature perhaps epitomizes the new performance budgeting approach.

- ***Devolution***

A more advanced move of reallocating decision-making from the central level to the implementing unit, by legally separating the agency, partially or fully, by giving it its own legal personality. Such bodies typically have greater freedom in policy making with clear restrictions on the intervention of central ministries in decision-making. In many countries these devolved bodies have boards—sometimes only advisory, but more usually a management board, and sometimes a governing board that sets strategy, and develops policies for implementing this strategy. The ministry usually participates in these boards, and in some cases can direct the boards but most usually the minister only has indirect control. These devolved agencies are often subject to different management and financial rules from the traditional vertically integrated ministries, and their staff are often not part of the civil service.

* Since in the OECD there are so many institutional hybrids, any all encompassing categorization is near nigh impossible. This typology should be recognized as only representing the stylized characteristics of each approach, and in reality many overlapping conditions exist.

Just as there is a wealth of international experience to draw on in the design of institutions, there are also a number of lessons to be learned. Many governments that have instituted reforms now being introduced in Russia subsequently realized that managing on a decentralized basis heightened accountability and control issues. In turn, this has led to the recognition of two critical aspects determining success. First, the importance of the *robustness of Public Expenditure Management (PEM) systems to accommodate increased devolution*, which in turn determines the possibility of establishing accountability at arm's length. Second, the need to address the choice and design of decentralized institutions to implement this approach, focusing on *the role of the "agency."* These two complementary components of reform may likely prove critical in ensuring the success of wider performance budgeting reforms in Russia.

IV. LESSONS FROM INDUSTRIAL COUNTRY EXPERIENCE: THE IMPORTANCE OF A SOLID PEM PLATFORM

There is a presumption that there exists some basic level of management expertise in government to make the performance approach effective. For example, previous studies have stressed the links between the level of public management systems and successful implementation of performance contracting.¹⁴ In successful countries the existence of management tools such as accrual accounting, contracting out, and other methods which allow programs and services to be "unbundled," have offered a starting point for performance management reforms. The latter requires developing the capacity to cost out individual activities, and relate these to specific outputs, and also to have internal controls in place to have some assurance of the reliability of these calculations. Performance management, therefore, cannot be viewed in isolation but must be seen as resting on a solid platform of public expenditure management.

From this perspective, some issues of particular concern in the Russian reform program should perhaps be highlighted.

Transactions costs in the new system can be high

While not denying the net benefits will be ultimately positive, the costs of introducing performance management can be high, at least initially. Generally, this results from transaction and compliance costs associated with negotiating and monitoring performance agreements, assessing and managing risk, and the difficulties in enforcing performance. Apart from their operating costs, there are also considerable start-up costs, largely associated with the investment in human resources. Performance management demands new skills and ways of operating that may impose considerable costs on an organization. Similarly, the need to build new information technology (IT) systems may impose significant real costs, where there is a need to share data and improve accounting systems. In the Russian case this may be coupled by the risks in the speed of change and the extent to which management styles must

¹⁴ OECD, 1999, p. 17.

be modified. While there is some recognition of these costs,¹⁵ it can be doubted if they are yet fully appreciated.

Defining performance is not easy

Apart from transaction and operating costs, more fundamental problems have been identified in the literature. Many of these revolve round the difficulty in defining performance, an issue that is inadequately covered in the present plans. Should performance be defined in terms of outputs or the outcome of these outputs?¹⁶ Should performance be defined as a static concept or evolve over time? For example, after an initial period in which priority is given to reducing costs and improving productivity, performance may need to be adapted to broader objectives, i.e., units need to be not only more productive, but also more effective. Many OECD member countries acknowledge that defining objectives is a difficult task, and international experience has revealed a common problem is to set too many objectives, and to cover all sectors of an operating unit's activity, but fail to specify priorities. It is also acknowledged that the difficulty in measurement often means that any dimension of performance that can be measured may automatically become an objective.¹⁷ There is a marked and well-documented tendency to define procedures rather than simply stating objectives and instruments of control/evaluation.

There should be a meaningful program structure in the budget

This element in the Russian reform agenda does not seem to be adequately emphasized in current plans. Specifically, there is a need to review present government programs to ensure that there is a clear policy statement or list of objectives that adequately define the purpose of the programs, so that the results expected from the programs can be assessed and measured in some way and be reported. In turn, this will allow the introduction of more rigorous accountability mechanisms characterizing the performance budgeting approach. To date efforts that have been made to review existing government operations have revealed the scale of the challenges faced in Russia. In 2003 the MoF required all ministries, departments, and spending units to submit their reports and plans until 2006 on a program basis. Success in

¹⁵ "International experience shows, that for the transition to a new system of budgeting, in addition to the sustain ability of the balanced budget it is also necessary to perform deep transformation of the whole system of government management. Its fast introduction could lead to the slackening of financial discipline, reduced accountability and transparency of using budget funds, growth of managerial expenditures, unjustified complicity of budget administration." Budget Reform Concept Paper, p. 3.

¹⁶ Some OECD member countries such as the United Kingdom and New Zealand stress the measurement of outputs given that the autonomous unit is not generally perceived as responsible for outcomes (a matter for the ministry). Others, like Australia, measure outputs but emphasize the importance of knowing outcomes. Agencies are perceived as being involved in producing both outcomes and outputs and have to design impact indicators and measure results. Most OECD countries concentrate on measuring outputs, or if they measure the impact of public policies, they do it separately from the measurement and reporting of outputs.

¹⁷ Poor specification of performance can also lead to "gaming" in the setting of performance targets or misrepresentation of performance statistics. (Laking, 2002 p. 8).

formulating their budgets was then assessed using a 5-point scale. The average score was 1.84, with over 60 percent of participants getting less than 2 points, and only 12 percent received over 3 points. The ability of budget institutions to distribute budget expenditures by objectives and main functions scored an average 1.49 points—a key requirement for program/performance orientation.¹⁸ A further complication is the existence of extensive unfunded mandates, many of which have been ignored because of the lack of funds. Not only does this make the differentiation between old and new policy initiatives more difficult but also implies that these unfunded mandates should be addressed before the restructuring of government operations into meaningful programs.

There is a need to link program activity to performance

The new performance budgeting approach is more comprehensive than a simple refinement of budget programs. While using a program structure to introduce a performance orientation, it is clear that, to be effective, a program budget format must also be integrated into a wider model of budget management. Moreover, experience suggests that the benefits of a budget program format will soon be lost unless departments (and most central agencies) have the incentive to continue the momentum and purpose of the reform. This implies moving on to develop standards of service delivery and search for ways by which these standards can be continuously improved and services delivered more effectively. That is, government service delivery needs to be redefined in a more results-oriented manner. How to do this? The most effective way, at least from the experience of a few pioneering industrial countries, involves a fundamental revision of accountability relationships within the public sector.¹⁹ There is little in the Russian reform plans that indicate how the new accountability is to be designed and enforced. Certainly, the role of key institutions, the budget institutions' managers, the MoF, the DUMA, and the Chamber of Accounts, remains unclear.

The ability to measure and report on performance

The ability to measure and report on performance in a timely manner requires the existence of an adequate information management system. Improved accountability is dependent on adequate and timely information to judge performance. There is no point in designing and implementing a program structure with well-defined objectives if there is no information for their evaluation. The design of programs should take into account the practicality of constructing a comprehensive and regular information and reporting system to provide relevant data in a timely manner. In this regard, there has been a tendency in the literature to emphasize the development of performance indicators to the neglect of measuring the costs associated with performance resources.

For the program structure to be implementable, there must be adequate mechanisms to fully cost programs, so that the outputs of programs can be related to their budgetary costs, and

¹⁸ Reported in Kommersant March 26, 2004.

¹⁹ Discussed more fully in Diamond, 2004.

then ultimately to their benefits in order to judge program performance. Costs can be allocated on many different criteria.²⁰ From a program budgeting viewpoint, the more pertinent criteria are their direct or indirect association with the program. To do this, many practical problems must be overcome. First, the problem of indirect costs, or overheads, can prove difficult. The activities of any agency will include certain common staff functions, such as personnel and accounting, and an unapportioned activity such as general management, that are difficult to break down into specific activities. Second, the measurement of program costs is further complicated by the existence of joint products and activities by the same basic unit. To be able to separate them requires specialized accounting skills that are typically underdeveloped and often nonexistent in transition country governments like Russia's. Last, but not least, it is often argued that to capture full costs of providing government services ideally requires an accrual system of accounting, as is found in the private sector.²¹

The Russian authorities have acknowledged that the need for moving to accrual accounting in government, at least in principle, is a strong one. However, in practice, the case is less strong. For those countries that have attempted to move their government accounting systems to a full accrual basis the shift to accrual accounting has invariably proved difficult and costly. It could be argued that many of the costing benefits derived from accrual accounting can be derived by perhaps an intermediary move to accruals.²² The Russian authorities appear to be also following such a strategy, and for the present are maintaining central treasury accounting on a cash basis.

The institutional and legal framework

An important element in sustaining reforms revolves around the provision of an enabling legal and institutional framework. This has been fully taken on board by the Russian leadership. As indicated, there are already plans to amend the present Budget Code and similarly the Russian authorities have also introduced a radical administrative reform to provide a suitable institutional framework, to nurture these budget reforms. Unfortunately, these new institutional arrangements may also pose some problems, as discussed more fully in the following section.

V. LESSONS FROM OECD EXPERIENCE: DEVOLVED AGENCIES AS A PANACEA?

It is clear that in their design federal services and agencies offer much scope for devolution. This move may prove irresistible given that there has been a virtual explosion of interest in

²⁰ For example: by their nature (variable or fixed); production function viewpoint (output or non-output); decision-making (investment, sunk, opportunity cost); accountability (controllable or non-controllable).

²¹ In the commercial sector, the whole rationale of accrual accounting is to ascertain the true cost of "outputs"—i.e., it is an output-oriented accounting system.

²² This is discussed further in Diamond, 2002c.

devolved agencies in many countries since the 1980s.²³ This has arisen from a new set of motivations that have been added to the traditional ones that first fostered the interest in OECD member countries. The driving force for most OECD member governments has been the need to reduce spending, on the one hand, while on the other hand strengthening the effectiveness of the remaining spending by improving the quality and responsiveness of public service delivery. It is argued that the agency model offers the advantage of separating implementation tasks from policy-making, and by this more specific tasking within a separate entity it is expected that responsibilities will be better defined and more achievable. In this way performance targets can be specified more clearly, leading in turn to higher efficiency, economy in the use of resources, closer customer relations and hence more responsiveness to customer needs—i.e., higher quality of service.²⁴ One can detect such arguments in present Russian reform plans.

At the same time, for countries contemplating the move to more devolved institutional arrangements, such as Russia, there are perhaps some lessons to be learned from OECD experience.

The need for “institutional clarity”

An important message that has been conveyed by a recent major study by the OECD²⁵ on country experiences with devolved agencies is the need to clarify their institutional status and hence their accountability arrangements.²⁶ Countries should be clear on the criteria for creating devolved bodies. While this may seem a trivial requirement, many OECD member countries seem to have only addressed the problem of defining such criteria *ex post* during recent reforms. Historically, individual agencies have been established in response to specific needs, with their powers and attributes designed to respond to needs as perceived at the moment of their creation. Only later as part of the reform process have OECD member countries made an effort retrospectively to divide agencies into groups and create common management rules for the agencies in each group.²⁷ Following the New Zealand model, one

²³ Although such devolved units have a long history, for example, dating back to sixteenth century in Sweden, and the 1870s in Germany.

²⁴ To these “traditional” arguments have been added several new, perhaps less justifiable, ones. One specialized reason is legitimizing policy and insuring impartiality through a politically independent organization, for example, central banks, and regulatory and investigatory institutions. However, as Laking points out there are many others less justified: “Agencies may also be created to protect a function for legislative interference, pay off political allies or create power bases for specific functions, or to capture public assets or resources for private interests.” (Laking, 2002, p. 5).

²⁵ OECD, 2002.

²⁶ Gill points out how some governments have created problems for themselves by setting up many such organizations operating under different rules. New Zealand, a pioneer in the field, in the 1980s and 1990s created a wide range of new agencies out of government departments that led the present Labor administration to introduce legislation to bring some order and consistency into their governance arrangements (Gill, 2002).

²⁷ OECD, 2001, p. 27.

criteria often used and which can perhaps be detected in the Russian reforms, is that of purchaser and provider. However, splitting organizations into new and separate purchaser and provider organizations may involve costs that only become apparent with time. For example, one may be the loss of institutional capacity to learn from experience, and another the growing disconnect between policy and service levels.²⁸ A good deal of caution is also indicated when deciding on the legal status, mandate and powers that should be accorded to a particular agency because it has been found that an identical design model can produce vastly different consequences when applied to agencies with different types of tasks. One key factor appears to be scale: if the task requires that an agency be very large, it is likely to succumb to the same bureaucratic tendencies as any other organization of similar size and yet, on the other hand, it may prove powerful enough to disdain the control efforts of the supervising ministry.²⁹

For countries embarking on the creation of devolved agencies, a strong inference from OECD experience is that, to be more effective, this reform should proceed with a clear policy regarding the degree of autonomy that is to be granted. This will form a basis for determining their institutional status and accountability arrangements, as well as to classify existing institutions very carefully in law and financial regulations.

The need to create a framework for their management

If agencies are to fulfill the desired objectives of increased efficiency in service delivery the correct management framework must be put in place. There have been recent experiences of the dangers of granting independence to agencies without clarity in their responsibilities and their accountability. For those governments beginning these reforms there have been obvious problems in defining an agency's degree of operational independence, and the role of the ministry or supervisory organization. This aspect has been interpreted differently by different countries so that there is no ready model to apply.³⁰ Even when there is strong desire to make line units autonomous the relationship with the center inevitably remains hierarchical. The center assesses the public interest and hence needs to retain the power to amend the terms of any service contract it has with the agency. The determination of the limits of this asymmetry in power has proved a difficult one to define, as it determines the design of the mechanism by which the center will move to controlling at a distance.³¹

²⁸ An early criticism of the performance contracting system in New Zealand was the lack of incentives in purchase and performance agreements for chief executives to coordinate their policies and programs, to operate across organizational boundaries and to focus on longer-term issues of corporate capacity beyond the terms of the contract (p. 20).

²⁹ OECD, 2001, p. 24.

³⁰ The United Kingdom's Next Steps model has been widely influential. Even though it has operational independence, each agency is clearly responsible to its minister or parent department. However, clearly many contemporary agencies in other countries fall short of this. (Schick, 2002).

³¹ Example found in the slogan: learning to move from "rowing to steering." But as Schick points out, improperly applied the steering rather than rowing prescription may lead to government that does neither well. (OECD, 2002, p. 35). Delegating management freedom always runs the risk that the agency will not be fully

(continued...)

Ultimately, the central question to be answered is the degree of autonomy granted to the budget unit to propose its objectives. On the whole, the trend has been to increase this autonomy. Over time, some OECD member countries have come to recognize the value of allowing agencies latitude in choosing their modes of operation (e.g. sub-contracting, partnerships etc), even going so far as allowing them to adjust priorities according to their specific situation, provided they can justify that adjustment. Some countries have gone so far as allowing them to define their objectives and translate them into targets, simply because of their greater experience of problems on the ground. It is important, however, that such flexibilities are not granted by default through the poor capacity of the center to provide policy guidance and oversee results.³² The center must ensure improved monitoring and better defined accountability, so that the contracting parties are able to define who is accountable for what, in what form, and agree upon their reporting requirements.

The need to strengthen reporting/accountability mechanisms

In a devolved management setting, in return for their autonomy agencies should be required to report back on their activities, their results, and performance. That is, in exchange for flexibility in inputs they have to report more systematically on the results of using these inputs—their outputs and outcomes. This after all is the major reorientation at the core of performance budgeting reforms. Most countries have started to implement output- and some outcome-oriented reporting through activity-based costing, and some have put in place multi-year agreements and monitoring mechanisms. Again country experience is varied and there remain many open questions. For example, there are important measurement problems previously indicated—should performance be gauged by outputs only or by outcomes? Whatever the particular country solution, what is clear is that it takes several years of adjustment for large agencies to move from input to more output/outcome focused management. For many OECD member countries, this is a continuing process. This is something that the Russian authorities might well take on board in setting their reform timetable.

The need for new skills

The time required to adjust to the new devolved management framework largely reflects the time required to acquire new skills. Of course, the type of work that autonomous units carry out, and the skills they need to apply, will differ depending on the degree of autonomy they are accorded. These managerial skills can usually only develop if the unit has the means, either from its own resources, or brought from outside, to ensure a thorough understanding of its customers, to develop a strategic vision of its priorities, and to undertake a detailed

compliant with more general public interests. The power of the center's direction over the agency needs to be made explicit.

³² A risk that increases with the number of agencies. How is the center to ensure that agencies work together to meet important public objectives? Or how to ensure there is no overlap in responsibilities or that important areas are missed? The United Kingdom's recent initiative for "joined-up government" attempts to address this problem.

analysis of its environment. Typically, small units rarely have such skills. For this reason perhaps not surprisingly, devolved budget management tends to go hand in hand with devolution of human resource management, or even wage negotiations, to acquire the proper skill mix. However, this again brings managerial staff into areas for which they are not always trained.³³

Similarly, central government units may also face challenges in the new environment. Some writers have focused on the changing role of the budget office, but also the specific contribution of other central units must be redefined. Experience has revealed cases where the central units have not undertaken adequate policy analysis or policy development, rather defining their role as regulators.³⁴ In a more devolved budget system, central units are obliged to define their objectives more clearly and to give themselves the means to achieve them. This involved creating a forecasting capability, improving their understanding of technological issues, investigating customers' overall expectations and setting up units to carry through and monitor reforms. These units had to provide advice to line units, collate and evaluate approaches and draw up methodologies, guidelines and rules for action, as well as monitor autonomous units' performance. Devolution has also posed new challenges for Parliamentary control. Parliamentary committees often find it difficult to keep track of the different bodies created and the financial and management rules that apply to them; they need to develop capacity to analyze any performance data reported.

The need to nest devolution in a wider reform framework

In a number of countries, particularly at the political level, there has been a notable reluctance to embrace devolution. In some cases this reflects a view that compliance issues are judged more important than performance issues. In other countries lack of stability in the resource base, and the need for in-year adjustments to budgetary funding, create managerial problems.³⁵ In others, such changes may be adversely perceived as giving too much power to officials at the expense of elected representatives. They may also be perceived as opening up too many possibilities of improper or inappropriate behavior, especially in countries with noted governance problems. For example, it is important to ensure that agencies do not make borrowing decisions which create unsustainable contingent liabilities for the government,

³³ The quality of human resources may be a key factor in the success or failure of reform. To encourage managerial talent, employment contracts may be required. In the United Kingdom agency directors are appointed on fixed-term renewable (three or five year) contracts i.e., for the duration of the framework contract governing the agency. Incentive schemes may also be needed for staff to accept and integrate required changes. (OECD, 2003, p. 76).

³⁴ For example in France, see OECD, 2001, pp. 66ff.

³⁵ Even in OECD countries the need for safety valves is recognized. For example, the use of medium-term budgetary strategies is important in avoiding cuts. Some countries have a budgetary reserve to meet unexpected problems, others respect contractual commitments (Australia) or to guarantee resources for a specific period (Denmark, Ireland), so cuts can only apply to areas not covered by agency contracts. At the same time, moving too far to protect agencies from cuts imposed on others could be regarded as working against the flexibility that they are trying to promote.

extend public debt beyond the limits envisioned in the government's fiscal plan, or exceed the borrowing authority approved by the legislature.³⁶ It is important to stress that agencies should not be viewed as a "magic bullet." Rather, the full benefits of devolved budget management can only be reaped in a nurturing and supportive reform environment.³⁷

VI. AN ASSESSMENT OF THE RUSSIAN REFORMS

What do such considerations imply if reforms in Russia are to be accelerated along this path as planned? First and foremost, the OECD experience should sound a warning about the speed at which these reforms should be undertaken and the resources required to successfully introduce them. The source of these concerns is the public expenditure management baseline from which these reforms are to be initiated, which in some areas is rather weak in Russia. Specifically, there is concern over the human resource base on which these reforms hinge, both in the managerial skills within budget institutions, as well as at the center in managing the reform process. These concerns should perhaps be amplified.

A. The Speed of Reforms Contemplated

International experience points to the fact that success in institutional reform much depends on the strategy adopted for its implementation. Often, it is argued that a gradualist approach, that phases in the reform costs, both economic and political, is the safer approach. This, it is argued, allows the benefits of reform to become evident and also will give some scope for learning by doing (as well as learning from inevitable mistakes that will be made). The latter argument is felt to be most important when human resources are in short supply. From this perspective, the present Russian reforms are ambitious and "big bang" in their conception, with a short time horizon, and the presumption of a supportive human resource platform. While it can be argued that the low quality of human resources could be as much a consequence as a cause of the lack of reform, especially taking into account the low wages in the government sector, the removal of distortions in the incentive structure caused by low salaries should also be recognized as creating the necessary but not sufficient conditions for success. Sufficient conditions would also imply that the work force has the capacity to fully respond to the new incentive structure. While only the Russian authorities can provide an assessment on whether human resources will prove adequate, the experience of many middle-income countries in this regard is not promising. Efforts to improve budget systems have often failed from weakness in the management of the change process, and in particular

³⁶ This caution will be even more pronounced in some countries that have created agencies only to avoid fundamental political, institutional, or management reforms such as decentralization, civil service reform, or hard policy choices such as downsizing or deregulation. (OECD, 2001, p. 32).

³⁷ As so eloquently put by Schick, "It is naïve to assume that agents who opportunistically pursue self-interest when they are formally controlled by principals will be more compliant when they are organizationally independent. It is equally naïve to assume that departments which gave inadequate attention to service performance when operations were run by their own administrative subdivisions will be more attentive when services are hived off to independent entities." (Schick, in OECD, 2002, p. 46).

the underestimation of the resources, especially the human resources, required to carry out the reform.³⁸

B. The Preparedness of Budget Institutions

Under the previous budget management system, managers in line agencies seldom faced performance discipline. In the control and command budget system in which they have previously operated, they have not been required to manage resources to achieve a budgeted outcome because this control function was tightly controlled by the center. This reduced them to administrators of budget funds rather than managers. Becoming the managers that will be demanded by the new budget regime will also require an upgrading of basic management tools to provide adequate, relevant, and timely information. In particular, three aspects of this upgrading are worth stressing: restructuring the accounting system toward an accrual basis, greater application of IT, which is usually required to make this type of regime operative, and strengthening internal control systems. To a partial extent, the Russian authorities have recognized these requirements. As indicated, the new COA for government institutions, to be progressively phased in with the 2005 and 2006 budgets, has been designed to allow institutions to follow accrual principles. At the same time, there is a major computerization project underway within the Treasury system that will have some positive fall-out for budget institutions. However, countering this is the present low level of computerization,³⁹ and the absence of firm plans to modernize internal controls and audit systems.⁴⁰

C. The Change Management Strategy

A positive aspect of the present Russian reforms is that the central reform team is technically strong and shares common objectives that are fully congruent with government policy. Too often in other countries reforms have been negated by the lack of authority of the change management team. With reforms being pushed at the Presidential level, with a high level steering committee under the chairmanship of the deputy prime minister, and a minister of finance committed to this reform initiative, there is little doubt that there is great top-down pressure to reform being exerted on the budget system. At the same time, there may be inherent contradictions in attempting to install what is essentially a “bottom-up system” from the top down. To introduce more decentralized decision making, and greater managerial freedom, the Budget Policy Department as a leader of this reform strategy will be under pressure to adapt its work practices and build up information systems required for this new environment—this will take time and internal resistance may also be encountered. If staff at the center perceives that it is not in their interest the reform pressure may be dissipated. If, on

³⁸ Discussed more fully in Diamond, 2003c.

³⁹ Netreba, 2004a, questions how the 150,000 chief accountants in budget institutions will handle the new approach: more than 30 percent do not use computers and 35 percent of those who do, use in-house software.

⁴⁰ For a discussion of the importance of this aspect of budgetary management, as well as an approach to its development in transitional economies like Russia, see Diamond, 2003a.

the other hand, they try to reform too aggressively they may smother managerial initiative and encourage the old compliance mentality. The Russian approach of co-opting budget institutions into this reform with the incentive of augmented budget resourcing seems particularly useful in this regard.

D. The Need to Prioritize Reforms

Ultimately, resolving the conflicts involved in a top-down approach, will require restructuring incentives to support reform. International experience points to this as a crucial factor in countering the diminishing returns that often beset reform efforts.⁴¹ Apart from applying pressure from above, simultaneously the MoF should increase capacity from below: by spending time “selling” improved management techniques to budget institutions; by developing competencies in evaluating their programs and in better allocating their resources; and by helping the institutions develop performance indicators and institutionalize these in budget formulation. All this will take time and, undoubtedly, put strains on institutional capacity both at the center and in individual budget institutions. Given these constraints, there must be some concern that this broad-ranging budget system reform, encompassing policy, procedures, and institutional changes being pursued in parallel, may be too great a task for the reform management capacity and the reform effort may be dissipated. To avoid this fate, there may be the need to develop a more sequenced strategy with better defined stages, designated milestones of success, and clearer reform priorities.

E. The Absence of Wider Accountability Controls

There are risks as well as benefits in moving away from traditional budgeting methods, and many OECD member countries have seen it important to buttress budget system reforms with wider governance reforms—stressing transparency, reinforcing the legal framework of budget management,⁴² and introducing mechanisms of wider civic control. Clearly the focus of Russian reforms has been in enhanced accountability *within* the executive branch, so that budget managers rather than being held accountable for the correct use of inputs now are to be held accountable for the results of using those inputs. However, this it should be recognized as only one aspect of the overall accountability for the use of public funds. In addition there is the need for the executive to give a full account to the legislature on how it is meeting its responsibilities, enforced by an independent external audit body, reporting at least annually, to the executive. Often it has been felt these latter dimensions of accountability also require to be strengthened. For example, the external audit office needs to be better resourced, and required to reorient its work to better serve the needs of the legislature. This, in the new performance budgeting model, will require it to widen the scope of its audits away from narrow financial compliance with more emphasis on value-for-money audits. To strengthen accountability will also require greater transparency within

⁴¹ Discussed more fully in Diamond, 2002a.

⁴² The basic idea is to create rules and procedures that penalize the government from deviating from fiscal responsibility. The pioneer in this field was New Zealand and its Fiscal Responsibility Act of 1994. The Australian Charter of Budget Honesty and the UK Code of Fiscal Stability adopted a similar approach.

government. In this regard the recently published report for the Russian Federation on the Observance of Standards and Codes with respect to Fiscal Transparency, while noting considerable recent improvements in fiscal transparency also pinpointed a number of weaknesses.⁴³ While transparency in government operations is increasingly regarded as an important precondition for good governance, another channel to accomplish this is through empowering the government's clients: for example, 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. Currently, Russia has developed no such instruments to ensure wider accountability.

VII. CONCLUDING REMARKS

The above review should not be viewed as casting doubt on the direction of the reforms contemplated by the Russian authorities. Rather, it sounds a warning on the realism of the time horizon contemplated, the importance of not neglecting parallel reforms in human resource use, and the need to strengthen the underlying budget system. Despite these concerns, there is little doubt that the Russian budget system would benefit from these reforms. While one cannot underestimate the time and resources required in this effort in the short and medium term, it is also important not to underestimate the longer-time gains from these reforms. Notwithstanding the difficulties encountered in the OECD member countries and elsewhere, the verdict on performance-oriented budget management is generally positive.

A considerable part of this endorsement arises from the value added of the process itself, regardless of the direct results derived. The definition of objectives, the specification of the elements of the outputs of different activities, the effort in designing mechanisms to measure and monitor whether the participants are fulfilling the results expected, both as the budget progresses and at the end of the budget period, all have been judged as valuable exercises in their own right. This, perhaps, explains why, despite the emphasis placed on it, generally performance information does not directly affect resource allocations in most OECD member countries, but at the same time countries continue to pursue and refine performance-oriented reforms.

⁴³ IMF, 2004.

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