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BASIC STUDY
ON
PRSP/PUBLIC FINANCIAL MANAGEMENT
HANDBOOK
ON
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Chapter 1 Introduction

At the JICA office in country X...

Ms. A: The DFID manager asked me at today's donor meeting on PRSP monitoring whether Japan could help with public financial management. I told him that this was a field in which Japan did not have much experience, and I wasn't sure if there were staff capable to do this work. And, in addition, we don't provide general budget support, but it is an issue for future discussion.

Mr. B: PFM is a major issue for a country's budget and financial system, isn't it?

Ms. A: Yes, but JICA is mostly involved with technical cooperation at the individual sector level so we don't think about it much. That's an area best suited for people who have studied public finance and economics. To be honest, it's my weak point!

Mr. B: When I met the Permanent Secretary at the Ministry of Education in regards to the ex ante evaluation for a technical cooperation project to re-train math and science teachers, he asked me to give him a cost estimate of the aid over three years. He said he wanted to improve predictability and needed an estimate for the national budget. All I could do was tell him that I would look into it.

Ms. A: I've heard about this issue of "predictability" a lot recently at donor meetings. They say that donors should inform governments of the estimated aid amount to help improve developing countries' PFM.

Mr. B: But isn't that an issue for the Ministry of Finance? It was the Ministry of Education who asked me about it! I wonder if it's relevant at the sector level too.

Ms. A: By the way, did you see today's newspaper? Corruption is really terrible in this country! And not only in the central government, but in local governments too! When you think about it, we have no idea how our aid is actually being used. Last year's grant aid project to build an elementary school in province C was behind schedule too.

Mr. B: Despite all this talk in favor of devolution, all kinds of problems are occurring because local governments don't really have the capacity to use funds according to plan. When I went back to Japan last year, lots of my friends asked me if Japan's aid was just going to waste. Of course there are plenty of good examples too.

Ms A: The taxpayer's perception of things... I wonder if the Japanese government will really be able to increase the ODA budget?

To answer your concerns, Ms. A, it takes money to carry out the plans proposed in the Poverty Reduction Strategy Paper (PRSP). If we're involved in PRSP monitoring, we should be interested in whether the recipient government is preparing and executing a budget in accordance with the plan. Also, Japan has begun to provide support in the field of public financial management (PFM), and even donors not providing general budget support are helping in this area.

Mr. B, sector-level projects will not go well if the country's public financial management is unsound.

We also have to consider international aid coordination and alignment of donor procedures with PFM systems of the developing countries. Submitting aid plans and estimates of financial support to the recipient government is all part of effective PFM.

1-1 Background of handbook preparation

Effective and efficient development assistance requires attention to public financial management of recipient countries.

Many people think that PFM is so complex it can't be understood without a background in economics or public finance, as Ms. A assumed. They may also think that it has no direct relationship to JICA's technical cooperation, so they don't have much interest in what it is about. On the other hand, there are people involved in Heavily Indebted Poor Countries (HIPC) initiative and establishment and implementation of PRSPs, who in many cases, are not well-equipped with appropriate analytical framework and operational experiences to understand PRSP and PFM processes fully in order to prepare related aid programs. This is even more true for staff like Mr. B who works at the sector level. However, because of PFM's importance in managing organized activities, paying more attention to the PFM aspect of a sector-level program should lead to better sustainability.

The objectives of this handbook are to provide PFM-related information and examples, and thus to encourage readers to learn more about it.

Based on the premise that an understanding of PFM should be both important to and accessible for aid workers, this handbook is an attempt to help them change their likely perception that PFM is not relevant and cumbersome to understand. The handbook should enable them to recognize the importance of PFM, and encourage them to learn more about it. The authors intend to provide readers with information, aspects, and examples related to PFM so that readers will be able to communicate and coordinate effectively with governments and donors, and to perform the day-to-day activities of preparation and implementation of projects.

(1) What is PFM?

PFM is the system in which revenues and expenditures are managed through the budget process under the scrutiny of the public.

PFM refers to management of the economic activities carried out by a government to achieve its policy objectives. Government revenues obtained from households and the private sector in the form of taxes and public bonds are used to provide public services, and establish and maintain basic infrastructure. Thus, PFM is the system in which revenues and expenditures are managed and administered through the budget process under the scrutiny of the public. This budget process, which consists of formulation and execution of budget and audit of expenditures, is a key tool for the management and administration of public finances. That is why PFM is a crucial element of governance. In Chapter 3 the elements of PFM will be discussed in more detail.

(2) Importance of PFM

PFM plays an important role in democratic and capitalist countries in ensuring scrutiny of government functions by the public, efficient production of public goods, redistribution of income, and appropriate macroeconomic policy implementation. Effective operation of PFM influences economic growth and social stability through taxation where income is transferred from households and the private sector to the government, and it influences the budget process where the money is transferred back to the households and the private sector.

PFM plays an important role in ensuring scrutiny of government functions, i.e. production of public goods, income redistribution, etc.

An example of failed PFM is the expansion of a fiscal deficit financed by a central bank. This PFM operation without fiscal discipline results in hyperinflation, depreciation of local currency, flight of foreign capital, and increase in interest rates and prices of imported goods leading to an economic crisis that severely affects the livelihoods of the people. While PFM has these macro aspects, a closer look of PFM reveals that it consists of various micro elements, a government's day-to-day activities and procedures regulated by numerous laws and regulations. It is important to realize that the all-embracing concept of "public financial management" is actually made up of these micro elements, which will be discussed in Chapter 3.

Inadequate PFM operations most likely result in economic disorder.

PFM is supported by government's day-to-day procedures regulated by numerous laws and regulations.

We hope that this handbook will help change readers' perception of PFM as an elusive concept to practical and technical area which is tangible and concrete. This handbook should help readers analyze sustainability of development projects from the point of view of PFM, enhance their capability to analyze the PRSP process and sector activities from the point of view of PFM, and improve design and implementation of Japan's aid programs consistent with PFM processes in recipient countries. The overall goal of this handbook is to have readers feel eager to learn more about PFM particularly in developing countries.

The overall goal of this handbook is to have readers feel eager to learn more about PFM in developing countries.

1-2 Concept and principles of handbook development

1-2-1 Concept and areas covered

This handbook was developed to meet the needs of readers without prior knowledge of the PRS process and PFM.

This handbook was written for JICA staff members, project formulation advisors and technical experts, who are responsible for aid coordination and monitoring related to PRS processes, and Japanese assistance in the field of PFM. Since Japanese government officials and experts responsible for non-PFM sector programs are also targeted readers, the handbook was developed to meet the needs of readers without prior knowledge of the PRS process and PFM. The handbook should also be useful for Japanese embassy staff members involved in development assistance.

This handbook provides practical information that can be applied to day-to-day situations.

The objectives of this handbook are to provide clear explanations of the essential elements of PFM, and practical information that can be applied to particular day-to-day situations. This handbook is designed for readers to perform the following tasks effectively:

- To understand main points of PFM-related materials
- To understand and analyze client countries' PFM reforms, their directions and related issues
- To formulate, implement, and supervise projects in the context of PFM.

PRSP trends, PRS monitoring, aid harmonization are also explained in the context of PFM.

This handbook is concerned primarily with PFM. In addition, PRSP trends and monitoring are explained because they are closely linked with PFM in HIPCs. Because project development needs to be consistent with PFM processes and aid coordination frameworks in HIPCs, aid modalities such as aid coordination and budget support are also explained in the context of PFM. Although this handbook provides information and experiences essential for preparing and implementing development projects, specific steps necessary for project preparation are not discussed as these must be adapted to the particular working environment of the readers.

1-2-2 Guiding principles of handbook development

This handbook was written based on three guiding principles.

The handbook's first guiding principle is to describe the "why, what, and how" of

(i) Clear description of "why, what, and how" as related to PFM: The handbook answers the questions "why, what, and how" of PFM so that it will be accessible to a wide range of interested persons. Based on this principle the handbook is structured as follows:

- Why is PFM important? (Discussed in Chapter 2)
- What is PFM? (Discussed in Chapter 3)
- How should PFM be analyzed and assessed? How to handle PFM issues in development assistance? (Discussed in Chapter 4)

(ii) Emphasis on PFM's background and context: A number of PFM handbooks prepared by non-JICA donors mainly focus on the technical aspects of PFM without sufficient background information and descriptions of PFM contexts in developing countries. Thus, this handbook pays particular attention to explain this background and context to help JICA staff members and development experts understand the subject.

The handbook's second guiding principle is the emphasis on PFM's background and context.

(iii) Introduction of cases with practical applications: The last principle in writing this handbook was to provide information that would have practical applications in actual work situations. Sharing current PFM knowledge and examples of PFM programs and projects, mainly in Africa, with JICA staff and development experts will increase opportunities to apply the knowledge to their work. For example, the Medium-term Expenditure Framework (MTEF) and annual budget in Tanzania are presented and discussed, and practical knowledge relevant to day-to-day field situations are introduced in a question and answer format in Chapter 4.

The handbook's third guiding principle is the introduction of cases with practical applications.

Chapter 2 Why does PFM receive attention?

In this chapter, we will explore the reasons for the emphasis on PFM when trying to understand PFM in developing countries. First, the recent development-assistance trend which emphasizes the developing countries' ownership of projects supported by donors will be introduced. The trend has emerged to address issues related to aid efficiency as mixed outcomes of structural adjustment programs, the end of the Cold War, and tight public financial conditions in developed countries have increased concerns for aid effectiveness. Second, the way in which PFM has increasingly received attention from donors while Sector-wide Approaches (SWAps) have been introduced to overcome shortcomings of project-type development assistance will be discussed briefly. Lastly, donors' perceptions of PFM from the point of view of New Public Management (NPM), and reasons why we need to consider PFM of recipient countries for the effectiveness of Japanese development assistance will be discussed.

In Chapter 2, the reasons for the emphasis on PFM in the context of developing countries will be explored.

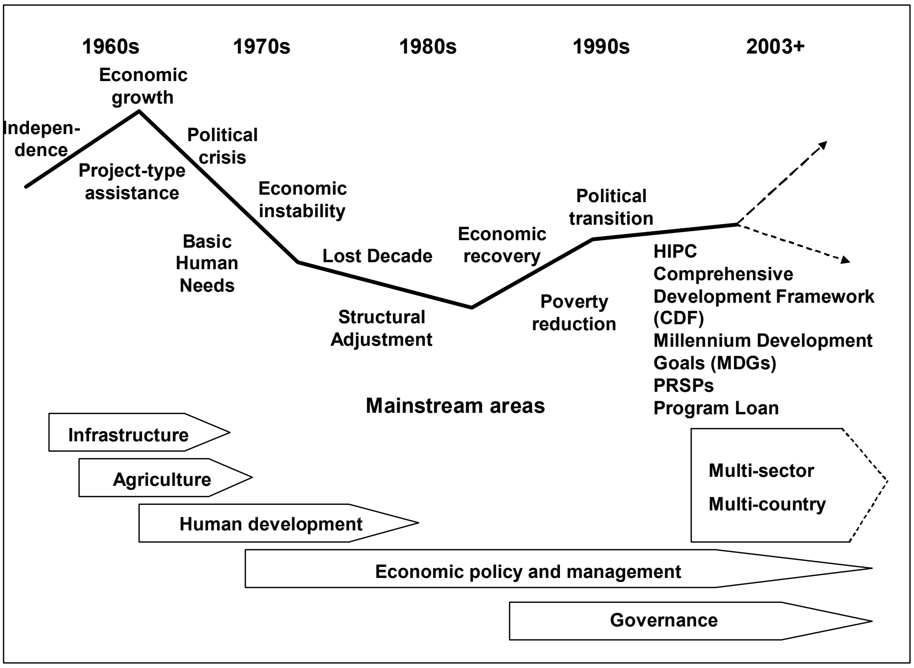
2-1 Trend of development assistance since the era of the Structural Adjustment

In the 1960s, large-scale agricultural projects and infrastructure development were implemented in African countries with the optimism that these efforts would help transfer the colonial economies to developed ones. However, it is argued that, in general, the countries have failed to meet these expectations. Although efforts have been made in the 1970s to meet basic human needs (BHN) through implementation of development projects, economic development in many African countries has stagnated (see Figure 2-1) due to external and internal factors such as the Oil Shock, currency crises, poor governance, and failure of economic management.

Although significant amounts of resources have been invested in Africa since the 1960s, economic development is deemed to be unsatisfactory.

In the late 1970s, the Reagan and Thatcher administration in the US and United Kingdom, respectively advocated the "New Free Economy" doctrine, which heavily relied on the free market mechanism. The World Bank's development policy also began articulating the importance of the market as the Bank's leadership shifted from McNamara to Clausen. Against this background, the International Monetary Fund (IMF) and the World Bank began supporting structural adjustment programs in developing countries in the 1980s to implement policies regarding macroeconomic stability, trade and price liberalization, privatization of public services, etc. Through these adjustment programs, HIPCs were able to obtain project funds from donors once economic conditionalities were met, which related to the reduction in governments' budget and market interventions, privatization, deregu-

In the 1980s, structural adjustment programs were implemented to achieve macroeconomic stability, trade and price liberalization, privatization of public services, etc.



Source: The World Bank "Strategic Framework for Assistance to Africa 2004"

Figure 2-1 Trend of development assistance policy

lation, and promotion of foreign direct investment. At a later stage, the adjustment programs included not only economic but also political conditionalities, such as the

Structural adjustment programs were implemented without national ownership of the programs.

Contrary to initial expectations, the structural adjustment programs attracted criticism due to continued slow economic growth in Africa where the programs were implemented. Issues raised by critics related to the nature of the programs are summarized as follows:

- The structural adjustment programs were implemented without sufficient consideration to specific conditions of each country, and therefore, national ownership of the programs was not sufficiently nurtured
- The programs relied too heavily on the assumed market function for optimal resource allocations
- Poverty reduction had not received high priority in the programs, and thus haphazard market liberalization hurt the poor

The importance of ownership of devel-opment processes has been recognized in the late 1990s.

The recognition that insufficient attention was paid to national ownership of development efforts actually led donors and recipient countries to emphasize the importance of ownership in the late 1990s.

Introduction of PRSP

The World Bank initiated CDF which emphasizes importance of the national ownership.

The development of PRSP is the condition for application of HIPC initiative and provision of IDA credits.

PRSP has five guiding principles.

Based on the background described above, the World Bank initiated Comprehensive Development Framework (CDF), where the Bank advocates the importance of national ownership with the slogan of "putting developing countries in the driver's seat." In 1999, at the Annual Meeting of the World Bank and IMF, participating governments endorsed the PRSP approach which requires the development of a Poverty Reduction Strategy Paper (PRSP) as a condition for application of HIPC initiative, and for provision of International Development Association (IDA) credits.

PRSP is a medium-term comprehensive socioeconomic development plan with a clear set of policy and action priorities for the reduction of poverty. Development of PRSP requires strong ownership of governments and participatory consultations with a wide range of stakeholders, such as governments, donors, NGOs, civil society, and the private sector. In addition to 1) principle of country's ownership, the PRSP approach should also be 2) results-oriented, 3) comprehensive approach, 4) partnership-oriented, and 5) based on a long-term perspective for poverty reduction[1].

BOX 2-1: Millennium Development Goals (MDGs)

In September 2000, the member states of the United Nations adopted the Millennium Declaration which defines eight (8) development goals and 19 targets (Millennium Development Goals: MDGs) to be achieved by 2015. To monitor and assess achievements of MDGs, 48 indicators were also defined. PRSP is considered a medium-term policy instrument to accomplish MDGs.

In order to achieve MDGs, pro-poor public finance and allocation of budgets is required. Another important factor to consider with respect to the attainment of MDGs is the way budgets are prepared, not only how they are executed.

[1] JICA, 2001, *Tokubetu hokoku○uHinkon sakugen senryakusho (PRSP) toha○v*[Special report: What is PRSP]. http://www.jica.go.jp/activities/report/kenkyu/01_34/pdf/34_03.pdf

Issues of public debt in developing countries (HIPC initiative)

HIPC governments need to allocate shadow counter value generated from debt reduction to poverty reduction activities.

The HIPC initiative, proposed by IMF and the World Bank, and endorsed by donor countries, is a debt relief program addressing public debts of HIPCs. As stated above before, the World Bank and other donors request HIPCs to develop a PRSP as a condition to provide assistance. Under the initiative, HIPCs' governments are responsible to allocate a shadow counter value generated from debt reduction to poverty reduction activities in line with PRSP. In this case, the issue is whether HIPCs' governments have sufficient capacity and intention for efficient and effective allocations of resources to achieve poverty reduction objectives.

Donor countries are requesting improvement of governance and PFM as conditions for debt write-offs.

Although HIPCs have been reluctant to accept external interventions in their PFM, the debt write-offs[2] under the HIPC initiative have resulted in the donors' direct intervention in matters related to HIPCs' PFM and allocations of public funds. Before the HIPC initiative, the single standing condition for debt rescheduling or debt relief was a reform of a debtor country's PFM system. Contrary to this condition, the HIPC initiative requires the development and implementation of PRSP as a medium-term policy for poverty reduction as a condition for debt relief, thus governance becomes an important factor in meeting this condition. As a result PFM reform is viewed as an independent condition, but as a component of governance.

The concept of fungibility has gained importance in the context of development assistance through the PRSP and HIPC initiative.

The concept of fungibility has increasingly become important to consider in the context of development assistance through the PRSP and HIPC initiative. Because the shadow counter value derived from debt reductions and additional funds from donors are fungible, a recipient government is able to reallocate its own funds, which otherwise would have been used to finance activities supported by the shadow counter value and donor funds, to other purposes. In contrast, values provided by in-kind assistance seem to be less fungible, and it is argued that in-kind assistance is the better method for achieving project objectives without influencing resource allocations external to the project. However, in-kind assistance also has government-wide effects due to fungibility of values provided. For example, assistance for the construction of school buildings can be done through providing funds for construction or in-kind contribution of school buildings. Either way, the recipient government, which had prepared its own budget for the construction, benefits and is now able to allocate these surplus funds to other purposes. Along with the

[2] One of the important aspects of the debt crisis in developing countries is whether the countries are considered under the condition of illiquidity or insolvency. Governments supporting HIPC initiative understand that the countries are insolvent, and IMF, the World Bank, and creditor nations have made first-time debt write-offs for HIPCs.

perception that the outcomes and effects of development aid have been disappointing, donors became increasingly aware of the ways resources provided by them are utilized, as well as the allocations and uses of funds available to recipient government for reallocation[3].

Donors became increasingly aware of allocations and uses of funds available to recipient government for reallocation.

2-2 Lessons learned from project-type assistance

It is argued that the World Bank and IMF proposed the PRSP approach in response to criticisms of the structural adjustment programs, Sector Wide Approaches (SWAps) have been adopted as a new aid approach in order to address issues arising from uncoordinated implementations of numerous donor-led projects.

SWAps have been adopted to address issues arising from uncoordinated donor-led projects.

In the middle of the 1990s, in Tanzania, the well-publicized Helena Report[4] pointed out that about 2000 projects supported by more than 40 donors were implemented without coordination among them, and that the government of Tanzania was not able to assert ownership of these projects resulting in their donor-led implementation. The report marked the starting point in the donors' recognition of the recipient government's ownership of development processes. In other countries as well, lack of government's ownership, increase in transaction costs, low sustainability of project operations, ineffective extension efforts, etc. were pointed out as problems resulting from isolated and uncoordinated project-type development assistance. To overcome these problems, SWAps in which in close collaboration between a recipient country and donors, a sector-wide development strategy is formed and implemented, and the Common Basket financing instrument (see below) was introduced.[5]

The Common Basket financing instrument was introduced to implement SWAps.

Sector Wide Approaches (SWAps)

SWAps can be defined as a "development approach based on the establishment of sector policies and strategies, medium-term sector development frameworks, financial and assistance plans consistent with national budgets, annual work plans, and implementation procedures." Effective management of the approach requires ownership of the recipient country and a well-defined partnership arrangement between the country and its donors.

SWAps are development approaches based on medium-term sector policies and financial plans consistent with national development frameworks.

Government's ownership is regarded as the most important factor for success of SWAps, and therefore, governance issues such as policy formulation and imple-

Government ownership and governance are the most important factors for the success of SWAps.

[3] Takahashi, Motoki, 2005, Fungibility and development aid, Kokumin keisazai Vol. 191-6.
[4] 1995, "Report of the Group of Independent Advisors on Development Cooperation Issues between Tanzania and its Aid Donors."
[5] Furukawa, Mitsuaki, "Sector-wide approach and choice of Japan." http://www.grips.ac.jp/forum/jsid/furukawa.pdf

PFM capacity is important for the success of both SWAps and PRSP implementations.

mentation capacity of sector ministries need to be addressed. The Common Basket arrangement has been proposed as a financial instrument of SWAps. In Common Basket arrangement donors pool their funds in a common fund from which money is released to finance SWAps implementation. In this case, the issue is whether a recipient government or a sector ministry has the necessary capacity to handle funds of the Common Basket appropriately. Since SWAps are approaches to attain PRSP objectives, SWAps and PRSP share the same conditions for their successful implementation, which are the establishment of comprehensive policies and strategies, and formulation and execution of sound budgets for their implementation based on the country's ownership.

General Budget Support

General budget support is an assistance modality in which donors provide funds to a recipient government's treasury account.

Donors of general budget support provide assistance in the field of PFM to reduce fiduciary risks.

General budget support is an assistance modality in which donors provide funds to an account opened by a recipient government with the treasury or other financial institution. Although the use and outcomes of funds are jointly managed by the government and the donors, funds contributed by the donors are not earmarked (without particular designations). The advantages of this aid modality are an increase in ownership of the government over external resources by allowing the government to jointly manage the resources, and consequent improvement of its management capacity. However, appropriate fund management capacity of the recipient government is an important prerequisite for the assistance. Donors of general budget support pay attention to the level of capacity, as well as the level of fiduciary risks (risks associated with responsibility to look after someone else's money in a correct manner), and provide various assistance in the field of PFM to reduce the fiduciary risks.

2-3 New Public Management (NPM)

The principles of NPM, which became popular in the United Kingdom and New Zealand in the middle of the 1980s, have influenced PRSP's operational principles such as result-oriented policy and strategy, and attention to capacity of recipient governments and ministries. NPM is a public administration theory which introduces private-sector business administration principles and methodologies to the management of public operations in order to improve their efficiency and effectiveness[6]. In the 1980s, the NPM theory relied on the government-market dualism in order to argue for a minimum role of government. However, in the 1990s, NPM theorists begain to realize the importance of government's functions, and advocated a theoretical background for efficient government.

NPM have influenced PRSP's operational principles and attention to capacities of recipient governments.

The current NPM theory consists of three components: 1) revision of roles of public and private institutions which is reflected in, for example, discussions of privatization, 2) introduction of policy assessment and result-oriented management, and 3) PFM reform which includes the reduction of the budget deficit, reconsideration of budget formulation processes, improvement of financial and accounting regulations and procedures.

NPM introduces private-sector administration principles to the management of public operations.

Donors have applied NPM principles in support of recipient governments' efforts to improve their governance. Especially in African countries, the United Kingdom and other donor countries have been experimenting with various types of assistance. For example, for the purpose of strengthening PFM capacity, assistance to the introduction of Medium-term Expenditure Framework (MTEF), Activity-based Budgeting, and Performance Budgeting has been provided by donors.

Some donors have applied NPM principles in support of recipient governments' efforts to improve their governance.

MTEF, a three-year budget plan, provides guidelines for the annual budget formulation. However, MTEF is not an absolute three-year budgetary constraint, but is a rolling plan which is subject to annual revision based on the economic and financial situation. It is expected that through establishing MTEF, a government's budget will be formulated and implemented in accordance with medium- to long-term plans for poverty reduction and fiscal discipline. In some countries, MTEF is formed to provide financial backing for PRSP which also has a three-year planning cycle.

It is expected that through establishing MTEF a budget will be formulated and implemented in accordance with medium- to long-term plans and fiscal discipline.

6 Sojiro Osumi, 1999, Nyuu paburikku manejimento: rinen, bijyon, senryaku, [New public management: concept, vision and strategy].

2-4 Improvement of effectiveness of development aid and PFM

Alignment of donors' aid procedures to recipient governments' policies and procedures has been requested to reduce transaction costs.

Under the ownership of recipient governments, formulation of PRSP and other development strategies is an ongoing process. In order to ensure the realization of such strategies, financial backing plans (MTEF, etc.) were formulated, and monitoring systems for the assessment of policy effectiveness were strengthened. Along with these efforts by governments, coordination among donors and alignment of donors' aid procedures to recipient governments' policies, and institutions, procedures have been requested to reduce governments' administrative burdens and transaction costs.

In March 2005, Paris Declaration on Aid Effectiveness includes 12 commitments of both recipient and donor governments for the improvement of aid quality.

In March 2005, the minister-level meeting of "High-Level Forum on Aid Effectiveness" convened in Paris with the main theme of how to improve aid effectiveness through promoting harmonization and alignment. The results of the meeting were summarized as Paris Declaration on Aid Effectiveness which includes 12 commitments of both recipient and donor governments for the improvement of aid quality, and the quantitative indicators of progress to be achieved by 2010[7]. As shown in Table 2-1, in order to achieve these commitments, PMF in recipient countries should be given particular attention as it is a vehicle for the implementation of commitments.

Alignment of aid with PRSP and other development strategies has been implemented to improve aid effectiveness.

As represented by the Paris Declaration, both recipient and donor countries have been working together on the alignment of aid procedures with the recipient government's PRSP and other national development strategies, capacity building in the field of PFM and public administration, and strengthening the fund absorption capacity to improve aid effectiveness. These improvements should be achieved regardless of the type of approach, i.e. project- and program-type assistance, and general budget support.

To improve effectiveness of JICA's aid, active participation in PRSP and SWAps is necessary.

JICA's country business plan should be aligned with national development plans, and JICA's aid needs to be consistent with country's PFM systems.

To improve the effectiveness of JICA's aid, active participation in the processes of PRSP and SWAps is necessary. Since PRSP and SWAps are jointly managed by the recipient government and donor, active participation is essential to understand the country's development strategies and budget, and to form well-prepared projects consistent with the strategies. JICA's intellectual contribution to these processes is also desirable. JICA's country business plan should be aligned with recipient government's national development plans, and project evaluation should be conducted from the point of view of the project's contribution to PRSP implementation. It is also required that implementation of aid should be consistent with recipient country's PFM systems. For example, formulating a development project in MTEF

7 http://www.oecd.org/dataoecd/11/41/34428351.pdf

by releasing donor's budgetary information, is one important way to make the project consistent with PFM. To manage development aid in this way requires an understanding of PFM for the improvement of recipient government's administrative capacity. In Chapter 3, the nature of PFM and ways to understand and assess PFM will

Table 2-1 Paris Declaration on Aid Effectiveness and Public Financial Management

Indicators		Implication for Public Financial Management
OWNERSHIP		
1.	Number of countries with national development strategies (including PRSs) that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets.	Not only PRSP but also systems of MTEF and annual budget formulation are required to be established.
ALIGNMENT		
2.	Number of partner countries that have procurement and public financial management systems that either adhere to broadly accepted good practices or have a reform program in place to achieve these.	Establishment of sound public financial management and procurement systems are required.
3.	Percent of aid flows to the government sector that is reported on recipient country's national budgets.	Donors need to understand recipient country's budget systems.
4.	Percent of donor capacity-development support provided through coordinated programs consistent with recipient governments' national development strategies.	Donors need to assist improvement of recipient countries' public financial management systems.
5.	Percent of donors and of aid flows that use public financial management and procurement systems in recipient countries, which either adhere to broadly accepted good practices or have a reform program in place to achieve these.	Donors are required to use public financial management systems of recipient countries.
6.	Number of parallel project implementation units (PIUs) per country.	Sound capacity of public financial management systems of recipient countries is required to reduce number of PIUs.
7.	Percent of aid disbursements released according to agreed schedules in annual or multi-year frameworks.	Donors' schedules and procedures should be consistent with recipient countries' public financial management systems.
8.	Percent of bilateral aid that is untied.	Recipient countries sound public financial management and procurement systems are required.
HARMONIZATION		
9.	Percent of aid provided as program-based approaches.	Donors need to understand recipient countries' financial management systems for implementation of program-based approaches.
10.	Percent of field missions and/or country analytic work, including diagnostic reviews that are joint.	Field missions and analytic work need to be synchronized with recipient countries budget cycles.
MANAGING FOR RESULTS		
11.	Number of recipient countries with transparent and monitorable performance assessment frameworks to assess progress against the national development strategies and sector programs.	Since performance assessment frameworks focus on outcomes of investment, efficient allocations of funds require sound public financial management systems in recipient countries.
MUTUAL ACCOUNTABILITY		
12.	Number of recipient countries that undertake mutual assessments of progress in implementing agreed commitments on aid effectiveness including those in this Declaration.	The agreed commitments include ones related to public financial systems in recipient countries.

Source: OECD website.

Chapter 3 What is Public Financial Management?

3-1 Public Financial Management

(1) Defining public finance

Public finance refers to a government's economic activities carried out to achieve policy objectives, and PFM is the management and administration of such economic activities. The government carries out various activities to provide public services and establish and maintain public infrastructure relying on revenues from, for example, taxes and public bonds. Thus, public finance can be defined as collection of funds from the private sector[8] and allocation of the funds by the government for generation of public goods, while PFM refers to government's management and administration of the collection and allocation of funds under the supervision of citizens through parliamentary control. PFM is thus a crucial element of governance.

Public finance refers to the government's economic activities carried out to achieve policy objectives, and public financial management is the administration of such economic activities.

An important role of public finance is to facilitate the smooth functioning of the market economy. If there was no public sector and a society relied only on the market economy for service delivery, providers of services such as national defense and police protection could not charge beneficiaries since those cannot be identified, and therefore no provider would deliver such services. The poorest segment of society would have inadequate access to medical and educational services. Further, there would be no reason stopping firms from polluting the environment if there was no government forcing firms to cover social costs incurred by pollution. These are typical examples of "market failure" in economics. Therefore, the expected role of public finance is to address market failure by providing public goods and services for the establishment of conditions necessary for the market economy to function smoothly[9].

An important role of public finance is to facilitate the smooth functioning of the market economy.

(2) Budget process as part of PFM

What exactly is the relationship between public finance and the process of formulation, execution, monitoring, and audit of a budget? This handbook assumes that public finance is managed through the budget process -- in other words, PFM is equivalent to the budget process. Based on this understanding, the overall struc-

Public finance is managed through the budget process. The overall structure of the budget process is shown in Table 3-1.

[8] According to Higo (1993), the private sector includes households and firms (and their economic activities). Precisely speaking, a government collects revenue from the public sector through levying indirect taxes.

[9] Kawakita ed., 2004, p.2

ture of PFM is represented in Table 3-1. The explanation of the PFM elements in section 3-4 is based on this structure.

The overall picture of PFM in terms of the budget cycle with a focus on its reliability, comprehensiveness and transparency will be explained.

This section will explain the overall picture of PFM in terms of the budget process (the budget cycle) with a focus on its reliability, comprehensiveness and transparency. The budget cycle is composed of budget formulation, its execution, and external audit and oversight. Particularly in African developing countries, donor aid is an important part of government finances. In recent years, there has been discussion about aid modalities with an emphasis on improving PFM capacity of recipient governments. These discussions will be incorporated in the descriptions of donor aid practices.

In this handbook, PFM will be explained using Performance Measurement Framework developed by PEFA.

The overall structure of the budget process shown in Table 3-1 corresponds to the structure of PFM Performance Measurement Framework developed by the Public Expenditure and Financial Accountability project (PEFA). PEFA is a project aiming at PFM improvement in developing countries, and for the past three years was supported by the World Bank, IMF, EC, DFID, the governments of France, Norway and Switzerland, and Strategic Partnership with Africa. It is expected that governments of developing countries and donors will use this Framework to assess PFM status of recipient governments, and that the Framework will be essential information among those involved in PFM support.

Developing countries and donors are expected to use this Framework to assess PFM status.

Box 3-1: History of public finance and financial democracy

The "public" in public finance refers to the fact that in a democracy the citizens supervise government spending. Pre-modern and feudal governments, as well as absolute monarchies had full control of their spending. The ruler had proprietary rights over both the land and its inhabitants, and the national treasury was the ruler's personal possession. This meant the ruler was not accountable to the citizens for his/her government spending.

Financial democracy was established after citizens seized power from their feudal rulers. For example, during the Middle Ages, the British Parliament decided to restrict the monarchy's power, giving rise to the budget. This move was intended to prevent the monarch from levying taxes at will, but subsequently the restrictions were expanded to encompass spending as well, leading to the development of the current budget system.

In a financial democracy, citizens are required to pay taxes to the government and in return an elected legislature representing the citizens sets policy, and controls a budget to carry out these policies. However, in recent years these legislatures have been unable to exert enough control over a large and complex budget process, causing some governments to introduce New Public Management.(Higo, 1996)

Table 3-1 Overall structure of public financial management

Elements of Public Financial Management/Budget Process				PEFA-PFM Performance Measurement Framework[1]
Categories		Sub-categories	Basic Elements	
Cross-cutting features	3-4-1 Credibility of budget process		(a) Fiscal discipline (b) Prediction of revenues and expenditures by macroeconomic framework (c) Revenue collection functions (d) Execution of budget according to plan	A PI-1、A PI-2、 A PI-3、A PI-4
	3-4-2 Comprehensiveness and transparency of budget process	(1) Content of budget and information disclosure	(a) Classification of budget item (b) Information included in budget document (c) Disclosure of budget process and budget information	B PI-5、B PI-6 B PI-10
		(2) Public sectors covered in budget process	(a) Budgetary and extra-budgetary activities (b) Inter-governmental fiscal relations (c) Risk management in public sectors other than the central government	B PI-7、B PI-8 B PI-9
Budget cycle	3-4-3 Policy-based budgeting	(1) Budget cycle		
		(2) Policy and budget formulation	(a) Medium- to long-term policies and expenditure framework (b) Participation of legislature and ministries in formulating annual budget	C(i) PI-11、C(i) PI-12
	3-4-4 Management of budget execution process	(1) Execution of revenue budget	(a) Clear tax system and improvement of taxpayer compliance (b) Efficient tax collection (c) Securing revenue from sources other than taxes	C(ii) PI-13、C(ii) PI-14 C(ii) PI-15
		(2) Execution of expenditure budget	(a) Management of expenditure cycle and adjustment (b) Cash and debt management (role of treasury) (c) Payroll management (d) Procurement (e) Settlement of accounts	C(ii) PI-16、C(ii) PI-17 C(ii) PI-18、C(ii) PI-19
		(3) Internal control and internal audit		C(ii) PI-20、C(ii) PI-21
	3-4-5 Accounting and reporting	(1) Accounting practices	(a) Cash-based accounting and accrual-based accounting (b) Accounting and Integrated Financial Management System (IFMIS)	C(iii) PI-22、C(iii) PI-23
		(2) Accounting report	(a) Budget execution progress report (b) Financial report	C(iii) PI-24、C(iii) PI-25
	3-4-6 External audit and oversight by legislature	(1) External audit	(a) External audits by audit board (b) Fiduciary risk and corruption	C(iv) PI-26
		(2) Oversight by legislature and public	(a) Oversight of budget process by legislature (b) Oversight of budget process by public	C(iv) PI-27、C(iv) PI-28
3-5 Donor aid practices		(1) Alignment of procedures	(a) Predictability and information disclosure of donor assistance (b) Alignment of aid procedures	D-1、D-2、D-3
		(2) Accountability of aid	(a) Fungibility of aid funds (b) Aid for public financial management sector	

Note 1: For titles of PFM Performance Measurement Framework established by Public Expenditure and Financial Accountability (PEFA) project, refer to Table 3-2 on page 27.

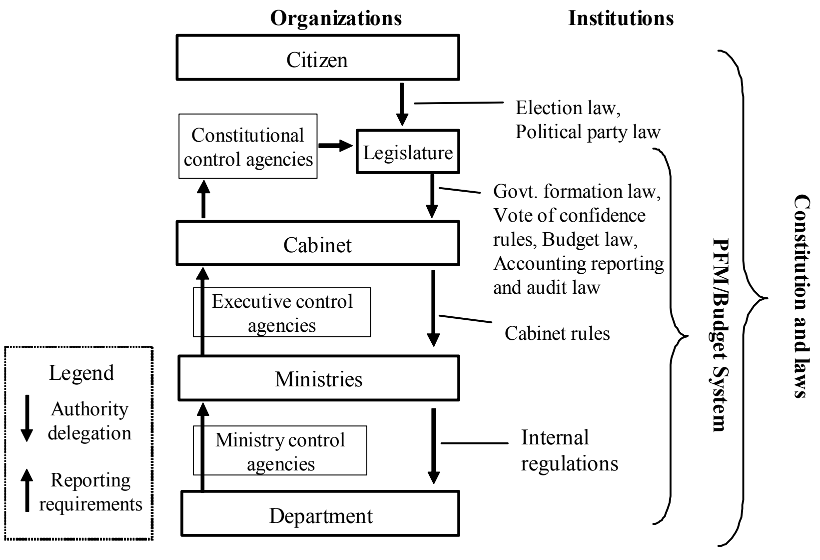
Public finance and the its mechanisms are institutionalized in that country's constitution, finance, accounting, and local government laws, and other legislation.

The authority to handle budget is entrusted by citizens to its government which must report back to the public. Government's accountability is guaranteed by the external audit institution.

(3) Organizations and systems supporting public finance

In general, public finance and the mechanisms developed for its management are institutionalized in that country's constitution, finance, accounting, and local government laws, and other legislation. Legislatures, finance ministries, other government ministries and agencies, central banks, accounting boards and local legislative and administrative institutions all play a role in PFM. Public agencies are also involved; for example, in Japan JICA and JBIC participate in PFM.

Figure 3-1 is a schematic presentation of the organizations and systems that carry out PFM. The authority to draft and execute the budget needed to carry out policies is entrusted by a country's citizens to its legislature and the government's executive branches. As a result, these executive bodies must report back to the public so that it may determine that the powers it has granted are being exercised fairly and properly. Internal auditors confirm that these reports are valid at every level of the administration. The authority of these audit functions are ultimately guaranteed by the external audit institution (e.g. the Board of Audit of Japan) which is independent of the administration, and is responsible only to the legislature[10].



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

Figure 3-1 Oranizations and institutions arrangement for PFM (in parliamentary system of government)

[10] There are many theories as to why this system of checks and balances must be built into the system. The field of political economics suggests that it is related to the "principal and agency problem," in which the organization that entrusts authority has different motivations than the subordinate organization to which authority is entrusted, or to "information asymmetry," in which the subordinate organization has more information concerning execution.

3-2 Three functions of public finance

We have already discussed the way in which public finance provides the foundations for a market economy. Specifically, it has three important functions[11]:

- Adjustment of resource allocation through the provision of public goods and services
- Redistribution of income through social welfare and progressive tax systems
- Macroeconomic stabilization

Three important functions of public finance are adjustment of resource allocation, redistribution of income, and macroeconomic stabilization.

(1) Adjustment of resource allocation

As introduced above, market economies are prone to "market failure" in the absence of a public sector, there are some essential goods and services that require the intervention of the public sector. In these areas, the government may intervene in their markets through subsidies and taxes, or serving as a direct supplier of these goods and services.

Adjustment of resource allocation can be conducted by market intervention to prevent market failure.

On the other hand, excessive intervention can impede the efficient allocation of resources, and often perpetuates vested interests, encourages red tape, deemphasizes results and incites corruption. These situations actually lead to "government failure." Accordingly, there has been growing interest recently in introducing market mechanisms, such as deregulation and privatization in areas that have typically been considered government responsibility.

Excessive market intervention can impede efficient resource allocation. Recently, market mechanisms have been introduced in public services.

(2) Redistribution of income

Even if a market economy efficiently allocates resources, distribution of income will not necessarily be fair. There is no single answer to the issue of how best to distribute money fairly. However, with the public's agreement, governments can intervene and correct excessively uneven income distribution when such distribution may result in social unrest.

Redistribution of income means adjustment of uneven distribution of incomes by administrative means.

There are two types of income redistribution systems: one focuses on the revenue and the other on the expenditure side. In the revenue side, a progressive tax rate is applied to income and inheritance taxes requesting the wealthier to pay higher taxes. In the expenditure side, a government covers the cost of social security measures such as welfare benefits, health insurance, pensions, and unemployment insurance. It also covers the cost of compulsory education, scholarships, and public housing. In this way, the government effectively uses cash and in-kind transactions to reallocate income to lower-income households and the socially disadvantaged.

Income redistribution systems are based either on revenue side or expenditure side measures.

[11] Kawakita, 2004, p.p. 3-6.

Public finance is also effective in ensuring temporally and geographically fair income distribution.

These methods ensure fairness among people of the same generation. Public finance is also effective in ensuring temporally and geographically fair income distribution. Pensions redistribute income from one generation to another, while unconditional grants to local governments from a central government redress income disparities between different regions.

Excessively progressive tax system could impede economic development.

However, if income is reallocated through an excessively progressive tax system, and if too big of a burden is placed on future generations, economic development could be impeded. Therefore, the negative impact of income redistribution must be carefully considered.

(3) Macroeconomic stabilization

Macroeconomic stabilization function of public finance is mobilized to minimize economic fluctuations.

Capitalist economies experience repeated economic fluctuations characterized by inflation and unemployment. Governments mobilize macroeconomic stabilization functions of public finance to minimize these economic fluctuations.

Public finance can prevent the economy from overheating when it is booming, and it can boost the economy when it is in recession.

For example, when an economy is booming tax revenue will increase out of proportion to the increase in incomes in countries that rely primarily on progressive income and corporate taxes which are sensitive to economic fluctuations. This lowers the increase in individuals'/firms' disposable income/profit in relation to gross income/profit, thus preventing the economy from overheating (when demand exceeds supply, resulting in inflation). On the other hand, in economic recession (when demand does not meet supply), tax revenues decrease out of proportion to the decrease in gross incomes/profits so that net incomes/profits and thus purchasing power remain relatively higher than the magnitude of the recession. As a result, personal spending and capital investment are stronger in relation to a weak economy, bolstering the economy. Assuming that the terms under which social security benefits, i.e. unemployment insurance, are paid do not change, benefit payments would increase (decrease) in weak (strong) economic conditions, boosting (reducing) consumption. This would stabilize economic fluctuations. This mechanism by which public finance stabilizes the economy is called "built-in stabilizer."

The economy can also be stabilized through implementation of public finance policy.

In addition to the functions built into the public finance/budget system, as described above, the economy can also be stabilized by adjusting budget processes. This is called discretionary fiscal policy. For example, during times of economic depression, the government can issue government bonds to increase fiscal spending, cut taxes or devise a budget intended to stimulate demand. When the economy is expected to overheat, however, the government can restrict its spending and delay execution of its budget, or raise taxes to hold down an effective

Box 3-2: Linguistic origins of "zaisei (=finance)" and "budget"

Zaizsei (Japanese for "finance": This term was first introduced in Japan in 1869 with the publication of Yukichi Fukuzawa's Zaiseiron (Financial Theory). Fukuzawa used the term zaisei to refer to what we now think of as "economic phenomenon." Zaisei began to be used as a translation for "public finance" to indicate "financial phenomenon" in the late 1880s. As such, zaisei was made up to provide a translation of a Western term, and is used even now in China as a translation for "public finance."

The term "finance" is based on the Latin word finire, meaning "to end." This was transmogrified from "to end" to "decision" or "fixed payment based on a court ruling" and eventually came to be associated with currency (Jinno, 2002).

Budget: English, French and German all use the term "budget" (budget, le budget, das Budget): This term derives from practices in the British Parliament and derives from "bulga" or "leather bag," of Gaulish origin, to refer to the leather pouch in which England's Chancellor of the Exchequer would put the budget.

The start of the financial policy speech by England's Chancellor of the Exchequer to signal the start of budget discussions was called the "opening of the budget." This was because the budget was kept in strict confidence until the Chancellor of the Exchequer opened his leather pouch holding the budget (Jinno, 2002).

[12] There are doubts as to the effectiveness of this type of discretionary fiscal policy. For example, this kind of policy could actually disrupt the economy as it is difficult to accurately ascertain economic conditions and there is a considerable time lag between the decision to implement a policy and its effect. Also in present-day democracies, the public interests in private goods override these in public goods. Whereas the public supports increases in public spending and policies that would lead to lower taxes, politicians find it difficult to attract support for cuts in public spending and higher taxes. Accordingly, discretionary fiscal policies can lead to chronic fiscal deficits and a bloated government, which in turn can rob economies of their vitality. In addition, the central bank's monetary policies, intended to be independent of the government's fiscal policy, can be influenced by these fiscal policies, further disrupting the economy (for example, inflation caused by the central bank's underwriting of government bonds).

demand[12].

3-3 "Good" Public Financial Management in developing countries

While developing countries appear to have impressive development policies, all too often they are not implemented effectively.

While at first glance developing countries appear to have established impressive development policies and plans, all too often they are not implemented effectively, slowing development. In many cases it is even impossible to determine whether these plans were carried out at all. One reason for this problem is that development policies are not effectively translated into a budget. In other words, PFM and the budget process fail to ensure that policies are implemented and generate results. Often this is not only because policies are being implemented ineffectively, but also there seem to be severe problems in governance such as corruption. There is the problem of poor foreign direct investment in the private sector, which is particularly susceptible due to corruption.

One reason for this problem is that development policies are not effectively translated into a budget.

"Good" PFM in developing countries ensures effective implementation of development policies.

These issues demonstrate the importance of "good" PFM in developing countries to ensure that the government successfully establishes development policies and achieves its objectives. Vice versa, sound governance is essential for "good" PFM. Developing countries must strengthen their PFM capacity to realize the countries' socioeconomic development.

(1) Perspective of PEFA's PFM Performance Measurement Framework

This handbook defines "good" PFM as using PEFA's PFM Performance Measurement Framework.

What standards should be used in determining whether a country's PFM is "good" or "not so good"? This handbook defines "good" PFM as using PEFA's PFM Performance Measurement Framework, completed in June 2005.

"Good" PFM is expected to have macro, sector, and organzation levels of PFM outcomes.

Figure 3-1 shows a schematic representation of PFM Performance Measurement Framework. Table 3-2 introduces the measurement indicators. Based on this framework, "good" PFM is expected to have three levels of PFM outcomes:

Level 1: Fiscal discipline: Effective controls of the budget totals and management of fiscal risks contribute to maintain aggregate fiscal discipline (national or macro level)

Level 2: Strategic allocation of resources: Planning and executing the budget in line with government priorities contributes to implementation of government's objectives (sector level)

Level 3: Efficient service delivery: Managing the use of budgeted resources contributes to efficient service delivery and value for money (organization level)

The macro-level PFM outcome is fiscal discipline which is essential for economic stability.

The first-level PFM outcome, fiscal discipline, is an outcome at the macro level, and is essential for economic stability, which is one of the three functions of public finance. A chronic fiscal deficit and lack of fiscal discipline expose a government to the risk of macroeconomic instability, such as high inflation and could pose obstacles to policy objectives. The second-level PFM outcome, strategic allocation of resources, is a desired outcome at the sector level. For example, a government could achieve the poverty reduction policy objective by strategically allocating its limited resources away from sectors that would be the least effective in reducing poverty (such as the military) and into sectors that would be the most effective in achieving this goal (education, healthcare, and rural development). This is related to the public finance's role of resource reallocation and income redistribution. The third level of PFM outcome, efficient service delivery, concerns efficient organization-level PFM. The budgets allocated to each public organization are used in a way that will most efficiently provide public goods and services, such as compulsory public education and public health service. This will allow all three functions of public finance to work effectively.

The second-level PFM outcome, strategic allocation of resources, is a desired outcome at the sector level.

The third level of PFM outcome, efficient service delivery, concerns the efficency of organizations.

The outcomes at these three levels relate to the degree of flexibility with respect to discretion in budget execution. Generally, budget execution as related to fiscal discipline at level 1 does not allow much room for flexibility. The extent of rigidity declines from level 1 to 2, and level 2 to 3, and giving the executing body greater discretion leads to more effective results. Even with this more flexible approach, the executing body still has to maintain accountability responsibility, and the check-and-balance system must be observed. Some developing countries are too strict at levels 2 and 3, while some are lax in fiscal discipline. Either of these cases can inhibit the country's ability to adjust to changes in the economic environment, lead to excessive spending commitments, and nurture corruption[13].

The outcomes at these three levels relate to the degree of flexibility with respect to discretion in budget execution.

"Good" PFM can achieve outcomes at these three levels. Then, what kind of budget process does this system specifically advocate? In the PFM Performance Measurement Framework, budgeting in "good" PFM has the following six characteristics (see Figure 3-2 and Table 3-2):

In the PFM Performance Measurement Framework, budgeting in "good" PFM has six characteristics.

- Credible budget process
- Comprehensive and transparent budget
- Policy-based budgeting for effective and efficient policy implementation
- Predictable and well-managed budget execution
- Accounting procedures ensure that budget execution is recorded and that

[13] World Bank, 1998, Public Expenditure Management Handbook, p.23.

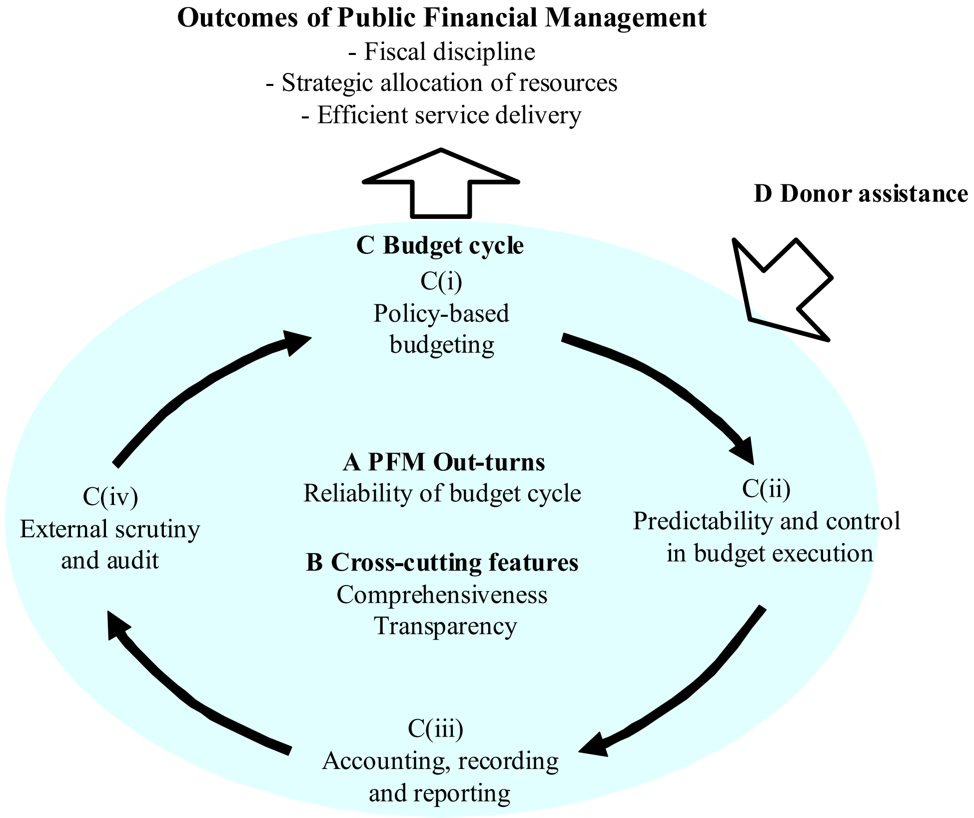


Figure 3-2 Structure and coverage of Public Financial Management Performance Measurement Framework

Additional important characteristic of "good" PFM is that donor practices are appropriate.

In the next section, the elements essential for "good" PFM and budget process will be discussed.

reports are made in a timely fashion

- Oversight by the legislature and external audit by auditing board

Donors' aid practices in developing countries that are dependent on donor funds and resources heavily influence these countries' PFM. Consequently, in addition to the six characteristics described above, it is also a very important characteristic that donor practices are appropriate.

In the next section, we will discuss the elements that PEFA deems essential for "good" PFM and budget process. Indicators used in the PFM Performance Measurement Framework, as shown in Figure 3-2 and Table 3-2, will give readers the perspectives needed to identify the characteristics and key issues of PFM in developing countries. Specific examples of PFM in developing and developed countries are provided to help readers better understand PFM.

Table 3-2 PEFA's PFM Performance Measurement Framework

I. PFM outcomes

1. Aggregate fiscal discipline: Effective controls of the budget totals and management of fiscal risks contribute to maintain aggregate fiscal discipline
2. Strategic allocation of resources: Planning and executing the budget in line with government priorities contributes to implementation of government's objectives
3. Efficient service delivery: Managing the use of budgeted resources contributes to efficient service delivery and value for money

II. PFM indicators

A. PFM out-turns: Credibility of the budget

- PI-1 Aggregate expenditure out-turn compared to original approved budget
- PI-2 Composition of expenditure out-turn compared to original approved budget
- PI-3 Aggregate revenue out-turn compared to original approved budget
- PI-4 Stock and monitoring of expenditure payment arrears

B. Key cross-cutting issues: Comprehensiveness and transparency

- PI-5 Classification of the budget
- PI-6 Comprehensiveness of information included in budget documentation
- PI-7 Extent of unreported government operations
- PI-8 Transparency of inter-governmental fiscal relations
- PI-9 Oversight of aggregate fiscal risk from other public sector entities
- PI-10 Public access to key fiscal information

C. Budget cycle

C(i) Policy-based budgeting

- PI-11 Orderliness and participation in the annual budget process
- PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting

C(ii) Predictability and control in budget execution

- PI-13 Transparency of taxpayer obligations and liabilities
- PI-14 Effectiveness of measures for taxpayer registration and tax assessment
- PI-15 Effectiveness in collection of tax payments
- PI-16 Predictability in the availability of funds for commitment of expenditures
- PI-17 Recording and management of cash balances, debt and guarantees
- PI-18 Effectiveness of payroll controls
- PI-19 Competition, value for money and controls in procurement
- PI-20 Effectiveness of internal controls for non-salary expenditure
- PI-21 Effectiveness of internal audit

C(iii) Accounting, recording and reporting

- PI-22 Timeliness and regularity of accounts reconciliation
- PI-23 Availability of information on resources received by service delivery units
- PI-24 Quality and timeliness of in-year budget reports
- PI-25 Quality and timeliness of annual financial statements

C(iv) External scrutiny and audit

- PI-26 Scope, nature and follow-up of external audit
- PI-27 Legislative scrutiny of the annual budget law
- PI-28 Legislative scrutiny of external audit reports

D. Donor practices

- D-1 Predictability of direct budget support
- D-2 Financial information provided by donors for budgeting and reporting on project and program aid
- D-3 Proportion of aid that is managed by use of national procedures

Source: PEFA PFM Performance Measurement Framework, 2005, p.9

3-4 Elements of PFM and performance indicators

This section follows the structure of the categories, sub-categories and basic elements shown in Table 3-1 on page 19. The titles of the PEFA performance indicators corresponding to the sub-categories are given in Table 3-2.

3-4-1 Credibility of budget process

Trusted and credible budget process requires democratic expenditure decisions which are based on reliable information.

The public must be able to trust the budget process, and this requires that democratic decisions on expenditures are based on adequate and reliable information. The reliability of this decision-making process is significantly affected by (a) fiscal discipline, (b) prediction of revenues and expenditures by macroeconomic framework, (c) revenue collection functions, and (d) execution of budget according to plan.

(a) Fiscal discipline

With fiscal discipline, revenue, expenditures, and debt financing do not have a negative impact on a country's economy.

Fiscal discipline, a PFM guiding principle, means that revenue, expenditures, and debt financing do not have a negative impact on the economy of a country. "Good" PFM is based on a budget process characterized by sound fiscal discipline. Because the levels of revenue could fluctuate significantly due to external factors, fiscal discipline in this case primarily refers to good control in spending decisions.

A government has the option to make discretionary spending decisions. It can spend more than the tax revenue for that year by supplementing this revenue with bonds and loans on the basis of its future tax revenue. However, this spending is predicated on future tax revenue, so the government's budget must be balanced (balance between revenue and expenditures) in the medium to long-term. Excessive dependence on this discretionary spending would result in chronic fiscal deficits[14] hurting the credibility of the government's fiscal policy, and spreading anxiety over future economic stability. Uncertainty about a government's financial outlook can also impair an economy's vitality.

(b) Prediction of revenues and expenditures by macroeconomic framework

It is important for the development of a credible budget to be able to estimate balanced revenues and expenditures through macroeconomic framework .

In addition to establishing the regular budget, the Ministry of Finance (or the equivalent institution) establishes the macroeconomic framework[15] and estimates the balanced revenues and expenditures within this framework. These estimates are important for the development of a credible budget. If these estimates were

[14] Japan is one of the world's largest debtor nations, with outstanding liabilities totaling 536 trillion yen at the end of fiscal 2002, equivalent to 108% of the GDP. This debt to GDP ratio in the US is 52% (based on 2002 figures), and 38% in England (2001).

[15] This is a simulation tool structured using various national economic estimation models and macro-economic models. Optimal revenue and expenditures are estimated using actual socio-economic data and adjusting for the variables.

inaccurate and the expenditures exceeded actual revenues, there would be a shortage in appropriations and the execution rate would fall. Even worse, uncertainty in the middle of a fiscal year in amounts available to carry out the budget, the timing of such appropriations, and budgetary adjustments inhibits systematic budget execution. Thus, the uncertainty would cause waste of limited funds.

Reliable socioeconomic data is essential for good predicting power of the macroeconomic framework, and this in turn requires high capacity of a government statistical department. When establishing the macroeconomic framework, targets are set in terms of economic policy (such as GNP growth rate), monetary policy (central bank rate), fiscal policy (changes in tax revenue, amount of government bonds to be issued), foreign exchange and trade policy (exchange rate, custom duties), external debt policy (changes in tax system, new external debt), policies in the private sector (regulations, policies promoting growth and development), and public sector policies (privatization of public agencies). Based on these targets and related assumptions, government revenues and expenditures for the next two to four years are simulated by the macroeconomic framework.

Based on targets and assumptions related to economic, monetary, and fiscal policies, government revenues and expenditures are simulated by the macroeconomic framework.

In addition to estimation methods using this framework, some countries estimate revenue by taking into account past tax revenue, as well as information on changes in the tax system, the extent of improvements in the government's ability to collect taxes, and budget execution in the previous fiscal year,The ability to estimate balanced revenue and expenditures through macroeconomic framework .

Some countries estimate revenue by analyzing past records of tax revenues and other related information.

PEFA has two indicators to assess a country's ability to estimate revenues and expenditures using a macroeconomic framework: "PI-1 Aggregate expenditure out-turn compared to original approved budget" and "PI-3 Aggregate revenue out-turn compared to original approved budget." The section below substitutes the budget execution rate for these indicators. A high execution rate means that the estimated revenues and actual revenues (equivalent to actual expenditures) were approximate to each other, which we assume to show positive correlation with the aforementioned indicators.

PEFA PMF
PI-1 Aggregate expenditure out-turn compared to original approved budget.
PI-3 Aggregate revenue out-turn compared to original approved budget.

Among the countries surveyed, Ethiopia (at the federal government level) and Uganda had high budget execution rates of approximately 100% and 95%, respectively. In Ethiopia, recent revenue budget execution rates are in the range of 95 to 105% showing good performance in estimation. This should be the result of the country's efforts to strengthen the functions of the Ministry of Finance since the 1990s with support from donors. Ethiopia's statistical department is particularly skilled in preparing socioeconomic data, and the country estimates revenues using

Recently, Ethiopia and Uganda had high budget execution rates.

Zambia and Malawi have serious difficulties in estimating revenue.

the macroeconomic framework with high accuracy.

On the other hand, Zambia and Malawi have serious difficulties in estimating revenue. The low accuracy of Zambia's estimates mean that it initially sets the budget at a minimal amount and then forms supplementary budgets in the middle of the fiscal year as more revenue is realized, revising its expenditures upward. As a result, Zambia has problems with the predictability and credibility of its budgets.

(c) Revenue collection functions (tax system)

Governments secure their revenue by levying taxes, issuing government bonds, selling goods and services, and currency creation.

In general, governments secure their revenue by levying taxes, issuing government bonds, selling goods and services, and currency creation. The government can also raise investment funds in the capital market. As described above, governments maintain fiscal discipline by limiting their reliance on issuance of bonds and currency creation by the central bank. These methods are described in more detail below.

Box 3-3: Japan's fiscal discipline

Japan relied on public bond issuance for 44.6% of its 2004 budget, demonstrating the severity of its fiscal condition even when compared to other developed nations (from the Ministry of Finance's website). In 1995, the then Minister of Finance Takemura declared a state of fiscal emergency, and in 1997, the Fiscal Structural Reform Law went into effect. This temporarily spiked interest in fiscal reconstruction, but the Obuchi Cabinet increased fiscal spending instead due to the financial crisis in 1997 and the prolonged economic downturn. The Fiscal Structural Reform Law was also discontinued. As a result, Japan's finances continued to deteriorate.

Japan's revenue in its 2004 budget was 45.5 trillion yen and expenditures were 82.1 trillion yen, leading to a discrepancy of 36.6 trillion yen that was met by issuing construction government bonds and deficit government bonds. The amount of loans is equivalent to approximately 80% of revenue collected.

The IMF and OECD are both concerned about Japan's fiscal condition. Argentina's economic crisis gave rise to discussions of whether Japan was really different from Argentina and whether Japan would meet the same fate in five years. Nearly 500 trillion yen public debts are properly managed, and according to plan, the debts will be repaied sometime in the future. In this respect, the Japanese government is perceived more credible than that of Argentina. However, if the Japanese government continues to keep the same pace in issuing bonds, it will have to fall into fiscal crisis, and thus, decisions to issue government bonds should be prudently made based on careful analyses of their impacts.

Levying taxes: The government imposes taxes on citizens and companies to generate revenue. The ethical justification for imposing taxes has changed with time, and a progressive tax system based on the theory of mandatory taxes[16] is currently the most common system. The taxation system can be divided into direct and indirect taxation. With direct taxation, the tax burden cannot be transferred from the taxpayer to another person, as exemplified by income, corporate, inheritance, and gift taxes. Indirect taxation shifts tax payment onto someone else, as with the general consumption tax whereby tax is collected from the store or business owner rather than from the consumer who paid the tax.

Based on the theory of mandatory taxes, the progressive tax system is the most commonly adopted system.

Direct taxes are deemed fair because of their progressive nature, and accordingly, the direct-indirect taxation ratio[17] is used to compare the fairness of different taxation systems. On the other hand, indirect taxes are an efficient way of collecting taxes. With the current emphasis on efficiency over fairness, some groups advocate lowering the direct-indirect taxation ratio (higher proportion of indirect taxes).

Direct taxes are deemed fair, whereas indirect taxes are an efficient way of collecting taxes.

Government bond issuance: The government issues bonds to borrow money from the capital market to fund its activities. It is generally deemed acceptable for governments to issue bonds to cover capital and temporary expenditures (such as government bonds to finance construction projects) and for taxes to be used for recurrent expenditures which ought not to be financed by government bonds. The bonds issued by the Japanese government are intended to finance recurrent expenditures and are thus violate this principle. Since the central bank's underwriting of these government bonds leads to the printing of currency, many countries prohibit their central bank from underwriting bonds.

The government issues bonds to borrow money from the capital market to fund its activities.

Sale of goods and services: The objective of government programs is to further the public interests and not to promote the interests of a particular individual or group through the sale of goods and services. However, many countries post part of the revenue from public agencies and companies managed directly by the government as government revenue.

Revenues from public agencies and companies form a part of government revenue.

Generation of currency: Governments can print bank bills passing as currency. Loans from the central bank or the central banks' underwriting of government bonds are tantamount to issuing currency. Since these are easy methods for

Governments can print bank bills passing as currency.

[16] Mandatory taxes began to be advocated as modern capitalism led to more severe poverty and social problems, overturning the assumption that the market could efficiently allocate income. This theory asserted that if the government's role was to ensure a just system and the market was not sufficient to ensure a fair allocation of income, the government must redress wrongs with a progressive tax rate (Higo, 1993, pp. 116-117).

[17] The ratio of tax proceeds from direct and indirect taxation.

the government to raise revenue, there are concerns that they could inflate budgets and impair fiscal discipline.

The government funds large and long-term projects using funds from government-affiliated businesses.

Raising investment and loan funds: The government's loan and investment programs consist of the government providing loans to large-scale and long-term projects that would not otherwise be implemented by the private sector. The government funds these projects using money from government-affiliated businesses, such as postal deposits and postal insurance, and money raised in the capital market on the basis of its credit strength. Public works is one area which has the comparative advantage of efficiency and effectiveness in operating with government loans. Government also provides loans to finance public projects, which can be profitable with fees paid by beneficiaries (for example, projects to build toll roads), and banking businesses which need to provide soft loans (for example, finance corporations providing soft loans to small and medium-sized firms, mortgages, and loans for international cooperation).

PEFA PMF
PI-3 Aggregate revenue out-turns compared to original approved budget.

The PEFA indicator to assess a country's ability to secure revenue is "PI-3 Aggregate revenue out-turns compared to original approved budget." By examining revenue estimates and actual revenue out-turns, capacities of tax authorities and revenue generating public agencies can be assessed. The trend of the ratio of tax revenue to GDP can indicate whether tax reforms have been effective or tax collection agencies have improved their capacity (refer to (a) in 3-4-4 for tax reforms and improving the capacity of tax collection agencies).

(d) Execution of budget according to plan

Budget must be executed as planned to ensure generation of policy outcomes.

Budget execution is an integrated function of a government.

The budget is allocated to government ministries and agencies for them to implement their intended policies. Thus, the budget must be executed as planned to ensure that outcomes of policies are generated. Budget execution is an integrated function of a government as multiple organizations are involved. All government functions must act properly to ensure that the budget is carried out effectively. If budget execution fails to generate policy results, it can generally be attributed to problems in a certain function of the budget process or failure of overall coordination among these individual functions.

PEFA indicators to assess whether a country's budget is executed according to plan are "PI-2 Composition of expenditure out-turns compared to original approved budget" and "PI-4 Stock and monitoring of expenditure payment arrears[18]." PI-2 measures variance in the actual and originally budgeted items. The more

[18] For detailed discussion see EFA-PFM Performance Measurement Framework.

actual expenditures vary from the original budget, the more reason there is to doubt the credibility of the original budget or the more problems there were with arbitrary fund allocation. If the PI-4 indicator shows that there is a significant amount of payment arrears, this would indicate problems with functions of budget execution (transfer of authority in executing budget, procurement, budget accounting, expenditure commitments and their management, management of arrears, cash flow management, budget appropriations and internal audits). If there are excess amounts of arrears, government credibility to meet liabilities owed to suppliers could be harmed. This situation would have negative impacts on the quality of goods and services provided by the suppliers, and on the timing with which they are provided. Negotiations for early payment could provide opportunities for corruption.

PEFA PMF
PI-2 Composition of expenditure out-turns compared to original approved budget.
PI-4 Stock and monitoring of expenditure payment arrears.

Zambia's government fails to allocate resources in accordance with the original budget in terms of both amount and timing, and often implements programs without secure allocation of funds. This indicates serious problems concerning arrears and their management. Malawi's government also fails to allocate funds as planned in its budget.

Zambia's government fails to allocate resources in accordance with budget.

3-4-2 Comprehensiveness and transparency of budget process

(1) Content of budget and information disclosure

Governments undertake a variety of projects involving large sums of money, and budget documents serve as the complex income and expenditure account statements for these projects. The budget process and the budget documentation are disclosed to the citizens, and thus must be easy to understand. Accordingly, the budget documents must outline the policy objectives, the bodies responsible for the execution, the description of projects, and the allocation of the funds, both comprehensively and in detail. In other words, the budget documents classify expenses in the appropriate budget category and describe policy objectives and projects clearly, and must be accessible to all citizens. In the section below, we will introduce (a) classification of budget item, (b) information included in budget document, and (c) disclosure of budget process and budget information.

Budget documents are disclosed income and expenditure statements of the goverment, and must be easy to understand.

(a) Classification of budget item

By classifying expenses under specific budget categories, the budget can be presented in a clear format to the legislature and the general public. With a clear format, the budget can demonstrate the relationships between policies, budget allocation, and the expected economic effects. It also is makes tracking and managing the budget execution easier. For example, budget expenditures are expressed in

By classifying expenses under specific budget categories, the complex budget can be presented in a clear format.

There is no international standard for programmatic classification, as countries set specific programs.

terms of economic, functional and programmatic classifications, representing the multi-faceted nature of the budget. International standards for economic classification and functional classifications (refer to Box 3-4) are established[19].

There is no international standard for programmatic classification, as countries set programs in accordance with a wide variety of policies. However, it is an important tool in budget formulation and execution, as well as program monitoring and evaluation.

Typically, each government agency (body responsible for budget execution) compiles its own budget. The budget is classified by budget item to demonstrate

Box 3-4: Expenditure classifications

Economic Classification

21 Compensation of employees	24 Interest
211 Wages and salaries	25 Subsidies
212 Social contributions	26 Grants
22 Use of goods and services	27 Social benefits
23 Consumption of fixed capital	28 Other expenses

Source: IMF, Government Finance Statistics Manual, p. 49
Note: Sub-classifications are shown for "compensation of employees." Only the main classification is shown for the other items. Codes are those of IMF's Government Finance Statistics (GFS).

Functional Classification

701 General public services	709 Education
702 Defense	7091 Pre-primary and primary education
703 Public order and safety	7092 Secondary education
704 Economic affairs	7093 Postsecondary non-tertiary education
705 Environmental protection	7094 Tertiary education
706 Housing and community amenities	7095 Education not definable by level
707 Health	7096 Subsidiary services to education
708 Recreation, culture, and religion	710 Social protection

Source: IMF, Government Finance Statistics Manual, p. 76
Note: Some of the sub-classifications are given for "education." Only the main classification is shown for the other items. Codes are those of IMF's Government Finance Statistics (GFS).

[19] For more details see IMF 2001, Government Finance Statistics Manual.

the budget's structure and the body responsible for budget execution. The object (line-item) classifications used in many countries' budgets should be based on the international standard for economic classifications (Box 3-4)[20]. Budgets using line-item classifications have the benefit of allowing detailed income and expenditure items to be set in advance, and each item can be carefully monitored. However, this system makes the budget less flexible, as it becomes more difficult to shift funds between items in the middle of the fiscal year. The theory of New Public Management advocates that budgets be allocated with an emphasis on results. In this system, budgets are distributed in units of "outcome," and the project manager is given a wide range of budgetary authority. However, this results-oriented approach requires a change in systems and organizational cultures. Thus, introducing this approach to developing countries would lead to mere reclassification of budget items and fail to produce results[21]. For this reason, efforts should be made to improve the current budget processes with line-item classifications in developing countries.

Developing countries that receive large amounts of aid from donors tend to use separate "development budgets" for projects funded by both donor and recipient country (see Table 3-3). This type of budget satisfies the country's responsibility to demonstrate the cost effectiveness of the project for which the donor provids assistance. This development budget also meets the donor's need for flexible appropriations and virements of funds without interference from recipient countries' national budget processes. However, this type of development budget places too

The budget is classified by budget item to demonstrate its structure, and the body responsible for budget execution.

Budgets using line-item classifications allow strict expenditure control, but this system makes the budget less flexible.

It is argued that the results-oriented budget approach may be too early to be introduced in many developing countries.

Table 3-3 Donor-assisted projects as shown in development budgets

Ministry
Department (subordinate to ministry)
Program
Current expenditures (covered by funds from national budget)
Capital expenditures (covered by funds from national budget)
Development expenditures (covered both by donor funds and national budget)
Current expenditures (operating expenditures)
Capital expenditures (capital and investment expenditures)

Note: Functional classifications are used for items coming under current and capital expenditures.

20 Asian Development Bank (ADB) 1999, Managing Government Expenditure, p. 73.
21 ADB 1999, Managing Government Expenditure, p. 69.

Although recipient governments tend to use "development budgets" to implement projects, this budget potentially impedes enhancement of their budget system.

much emphasis on the uniqueness and independence of the donor-supported programs. The development budget potentially impedes the development of the recipient country's budget formulation and execution system, and isolates externally supported programs from other government programs. Thus, aid modalities which align donors procedures with budget processes of recipient countries have been discussed and experimented with.

PEFA PMF
PI-5 Classification of the budget.

PEFA uses "PI-5 Classification of the budget" to measure the extent to which the budget formulation is based on appropriate classifications. For this assessment indicator Government Financial Statistics (GFS) and Classification of Functions of Government (COFOG), which are both IMF-formulated international standards, are used to assess PFM. For example, South Africa often being praised for its good budget[22], PFM reform has been implemented since 1998, and by 2004 the budget was formed completely in accordance with GFS and COFOG. Its budget is organized according to programmatic, economic and functional classifications. South Africa's budget system is a good example to keep in mind when considering ways to improve PFM capacity in Africa.

In South Africa, the budget was formed in accordance with GFS and COFOG of IMF.

(b) Information included in budget document

PEFA PMF
PI-6 Comprehensiveness of information included in budget documentation.

Budget documentation must include information on macroeconomic conditions and fiscal discipline, estimated costs and out-turn of previous years, and an explanation of the budgetary implications of new policy initiatives. This corresponds to PEFA indicator "PI-6 Comprehensiveness of information included in budget documentation." PEFA requires that, at a minimum, the budget and its supporting documents include information on the nine elements listed below.

Inclusion of information on the nine elements in the budget documents is required.

Information on macroeconomic condition and fiscal discipline (fiscal deficit or surplus)

(i) Macroeconomic assumptions, including at least estimates of aggregate growth, inflation and exchange rate
(ii) Fiscal deficit, defined according to GFS or other internationally recognized standard
(iii) Deficit financing, describing anticipated composition
(iv) Debt stock, including details at least for the beginning of current fiscal year
(v) Financial assets, including details at least for the beginning of current fiscal year

[22] Budgetary documents of the government of South Africa can be accessed at http://www.finance.gov.za/.

Budget requests and out-turn, as well as Medium-term Expenditure Framework

(vi) Previous fiscal year's out-turn, presented in the same format as the budget proposal

(vii) Current fiscal year's budget (either the revised budget or the estimated out-turn), presented in the same format as the budget proposal

(viii) Summarized budget data for both revenue and expenditure according to the main heads of the classifications used, including data for the current and previous year

Explanation of policies, as well as implications of policies and budget requests

(ix) Explanation of budget implications of new policy initiatives, with estimates of the budgetary impact of all major revenue policy changes and/or some major changes to expenditure programs

In addition to this information, some countries (such as Kenya and Tanzania) estimate expenditures for the next two fiscal years in addition to the budget requests for the following fiscal year. This is included in the budget documentation as the Medium-term Expenditure Framework (MTEF).

It is quite difficult to ensure that the budget documentation includes accurate information on all these elements. For example, (vi) calls for the previous year's settled budget out-turn, but many developing countries have a several years' backlog of audit, making it difficult to obtain information on the previous year's precise expenditures and revenues required to prepare a budget.

It is not easy for a government to ensure that the budget documents include accurate information.

(c) Disclosure of budget process and budget information

The public must have easy access to information on the budget, the government's fiscal status, policies and budget performance. This information must be of a high quality and be written so that a layperson can understand it, with an appropriate layout and structure. The means used to ensure public access, such as the press and the Internet, should be as diverse as possible.

The public must have easy access to information on the budget, the government's fiscal status, policies and budget performance.

The PEFA indicator "PI-10 Public access to key fiscal information" states that the public should have access to the following elements of information:

PEFA PMF
PI-10 Public access to key fiscal information.

(i) Annual budget documentation: A complete set of documents can be obtained by the public through appropriate means when it is submitted to the legislature

(ii) In-year budget execution reports: The reports are routinely made available to the public through appropriate means within one month of their completion

(iii) Year-end financial statements: The statements are made available to the public through appropriate means within six months of completed audit

(iv) External audit reports: All reports on central government consolidated operations are made available to the public through appropriate means within six months of completed audit

(v) Contract awards: Award of all contracts with value above approximately USD 100,000 equivalent are published at least quarterly through appropriate means

(vi) Resources available to primary service units: Information is publicized through appropriate means at least annually, or available upon request, for primary service units with national coverage in at least two sectors (such as elementary schools or primary health clinics)

Budget information can be accessed through the web in Burkina Faso, Ghana, Kenya, and Tanzania. In some countries budget information is not accessible by the public.

The public can access websites to view budget information in Burkina Faso, Ghana, Kenya, and Tanzania, but, available information on these sites is not necessarily comprehensive. However, South Africa's website provides comprehensive information on its budget. In Senegal, it is difficult to obtain government literature, and the government of Kenya has a minimal budget for printing budget documentation prohibiting better access to budgetary information by the public. As mentioned above, there are delays in information disclosure caused by delays in preparing financial statements and audit reports.

(2) Public sectors covered in budget process

The budget process must encompass all projects in the public sector in a comprehensive manner.

The budget process must encompass all projects in the public sector[23] in a comprehensive manner. This is to ensure that, based on comprehensive information of available resources, these resources are allocated optimally to various government's activities. It also sheds light on the public sector's overall management. This section will discuss (a) budgetary and extra-budgetary activities, (b) inter-governmental fiscal relations, and (c) risk management in public sectors other than the central government.

(a) Budgetary and extra-budgetary activities

Budgets and execution reports must include all government programs, including activities covered by extra-budgetary funds.

Annual budgets and their execution reports must provide information of all government programs, whether covered by budget appropriations or extra-budget-

[23] The public sector here refers to the government in the broadest terms (the central government, local governments including local autonomous bodies, social security funds, etc.) and public corporations and central banks under government control. Typically, public corporations are managed independently of the government, and legislative discussions of their budgets are thus conducted separately from the government's general budget.

ary funds. This ensures that the budget is comprehensive and transparent, enabling the public to monitor the entire activities of the public sector.

Extra-budgetary activities include the government's fund-raising and programs based on legislation approved by the legislature independently of the budget. Such extra-budgetary projects (examples include road and fuel taxes that can only be used for certain purposes, revenue from public corporations or revenue from donors[24]) are justified by the need to isolate priority investment areas from political debate, and ensure that the budget can be executed with flexibility, or protect projects receiving donor assistance from political interference. However, circumventing the legislature and public scrutiny in this way can lead to corruption. Based on this definition, Japan's projects and activities implemented under special accounts would qualify as extra-budgetary activities.

Extra-budgetary activities include government's fund-raising and programs approved independently of the budget.

PEFA indicator "PI-7 Extent of unreported government operations" focuses on the amount of funds, including funds for extra-budgetary activities, which should be included in budget documentation, but are actually not included. The lower the proportion of activities not noted in the budget, the more accurate the budget is in terms of its comprehensiveness and transparency.

PEFA PMF
PI-7 Extent of unreported government operations.

Ghana's road fund, for example, circumvents the budget process. This fund was established to maintain the country's road networks using a fuel tax which is not sufficient for the maintenance of the network. As a result, the fund receives money transferred from the government's general account, and donors have also provided funds. In contrast, Burkina Faso covers the cost of maintaining its country's roads with appropriations from the general account determined during the budget process, without establishing a special fund. Donors' off-budget aid impairs the comprehensiveness and transparency of national budgets, a point that will be discussed in greater detail in section 3-5.

Ghana's road fund circumvents the budget process.

Donors' off-budget aid impairs the comprehensiveness and transparency of national budgets.

(b) Inter-governmental fiscal relations

The public financial system consists of multiple bodies, and sub-national governments are important players in this system. Central governments began to take control of fiscal matters at the expense of local control in the late nineteenth century, but the twenty-first century represents a turning point as central governments around the world begin to delegate authority to sub-national governments. Central governments in developing countries are implementing devolution programs,

Sub-national governments, which can be characterized by degree of decentralization, are important elements of PFM systems.

[24] Even projects funded by donor aid that are included in the budget, but which are not audited by the beneficiary country's government, qualify as extra-budgetary activities.

transferring authority and financial resources to local governments. Communities were expected to cover the administrative costs of their own local governments, but there are marked gaps in local governments' abilities to raise funds. Central governments often provide funds to compensate for these fiscal discrepancies in order to ensure that its citizens share equitable tax burdens and that local governments are able to maintain a certain standard of administrative services. This compensation is provided by reallocating the government budget using the two methods described below.

Unconditional grants are provided by the central government to address discrepancies in sub-national governments' financial capacity.

Unconditional grants: Unconditional grants are general funds not earmarked for a specific purpose that are given by the central government to sub-national governments to cover their administrative and development costs. These unconditional grants are intended to address discrepancies in sub-national governments' financial capacity, cover shortfalls in their funds and standardize fiscal resources. This method also provides sub-national governments with a guaranteed amount of fiscal resources. Typically, sub-national governments with lower financial capacity receive more substantial grants.

Conditional grants are provided by the central government earmarked for specific use to sub-national governments.

Conditional (earmarked) grants: Central governments provide grants earmarked for a specific use to sub-national governments. These conditional grants may be applied to a wide array of activities, including public works, social welfare, education, and agriculture. These grants are often allocated to the local branch of a government ministry or agency, where the funds are then disbursed. These grants are also often included in the budgets of local autonomous bodies with self-governing structures for execution.

PEFA PMF
PI-8 Transparency of inter-governmental fiscal relations.

The PEFA indicator "PI-8 Transparency of inter-governmental fiscal relations" points to the need to assess the transparency of the rules by which the central government distributes the budget to the sub-national governments. The indicator is also used to assesses transparency of the process by which sub-national governments receive information on their allocations from the central government in advance, and by which the sub-national governments establish and implement plans.

Transparency of the funds granted to sub-national governments is very important.

In general, the ability of sub-national governments in developing countries to establish and carry out plans are inadequate. This ability must be enhanced, and external authorities must monitor the process. For this reason, the transparency of the funds granted to sub-national governments is very important. For example, in Ethiopia the legislature sets the formula used to calculate the amount of the unconditional grants allocated by the federal government to the state governments every year, and then releases this formula to the public. The formula uses the offset method (refer to the Glossary), considers the amount received from donors, and is designed to limit regional disparities. The amount of these unconditional grants is decided so that the timing coincides with the state and county governments' budget formulation. The counties have weaker PFM skills than the state government, and this must be addressed in the future.

(c) Risk management in public sectors other than the central government

The central government must oversee the management risks to which sub-national governments and autonomous government agencies are exposed. In many cases government-affiliated companies in developing nations have experienced operating crises instead of generating the anticipated revenue (for example, Mozambique's national bank), forcing the government to bail them out with capital injections. One of the objectives of the IMF and World Bank's structural adjustment programs in the 1980s was to raise the efficiency of these inefficient public corporations and government-affiliated businesses.

Central government must oversee risks to which sub-national governments and autonomous government agencies are exposed.

Accordingly, operating and financial information must be transparent for central governments to monitor operating risks and take action if necessary. Therefore, sub-national governments and public corporations need to release information such as sales management reports, quarterly financial statements and audited year-end financial statements in a timely manner. This corresponds to PEFA indicator "PI-9 Oversight of aggregate fiscal risk from other public sector entities," which provides guidelines for assessing the central government's capacity to gather and analyze operating and financial information, as well as the capacity to avoid operating risks.

PEFA PMF
PI-9 Oversight of aggregate fiscal risk from other public sector entities.

3-4-3 Policy-based budgeting

(1) Budget cycle

Budgets are formulated annually for a single fiscal year. Budgets are first drafted, then set, executed and settled. These steps are summed up as the "budget cycle." As shown in Figure 3-3, the budget cycle consists of three annual periods. In the first annual period the budget draft is formulated and approved by the legislature, in the second annual period the budget is executed with accounting used to manage expenditures, and in the third annual period an external audit is conducted, and the legislature discusses and approves the audit report. Since each of these steps -- budget formulation, execution, and settlement and auditing -- takes at least one year, each budget cycle covers a three-year period. In other words, three

Steps of drafting, approval, execution, settlement, and audit of budget are collectively called "budget cycle" which consists of three annual periods.

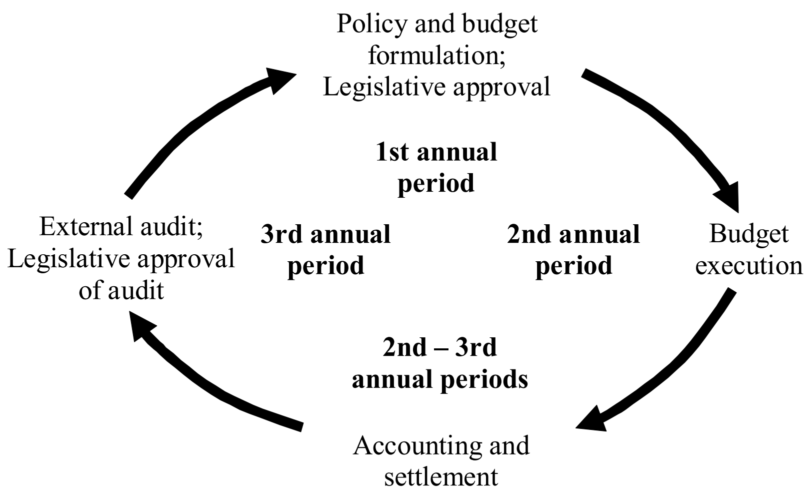


Figure 3-3 Budget cycle

processes, formulating the budget for the next fiscal year, executing the budget for the current fiscal year, and closing the budget for the last fiscal year, are performed simultaneously in a single fiscal year.

(2) Policy and budget formulation

PFM plays a key role in ensuring that a government's medium- to long-term policies are reflected in fiscal budgets.

Development occurs tipically over a medium- to long-term period, thus a government's short-term investments cannot be expected to lead to significant development outcome. As a result, the government's development policies must be carried out with a medium- to long-term outlook. PFM plays a key role in ensuring that the government's medium- to long-term policies are reflected in fiscal budgets, and are accurately broken down into components that can be accomplished in a single fiscal year. Typically, these medium- to long-term policies are revised every year according to changes in the economic environment and the budget outcome, and are taking the form of a rolling plan. In this section, we will discuss (a) medium- to long-term policies and expenditure framework, and (b) Participation of legislature and ministries in formulating annual budget.

(a) Medium- to long-term policies and expenditure framework

Long- and medium-term policies are incorporated into and implemented by annual budget.

PFM translates policies into budget form for implementation. Typically, governments set long-term policies covering a ten-year period and medium-term policies covering a three to five-year period. These policies are incorporated into the annual budget, which provides the means for implementing these policies. This method makes the annual budget consistent and predictable, and also ensures that major policy shifts are made systematically and without waste.

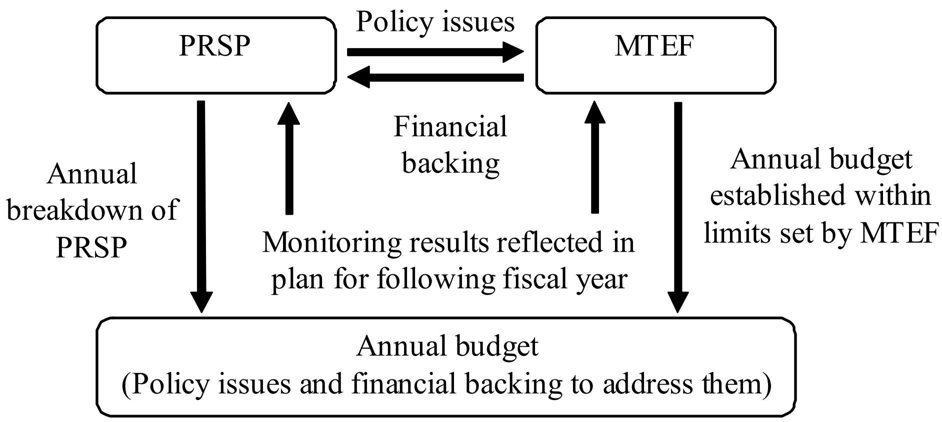


Figure 3-4 Relationship between PRS process and budget cycle

Long-term plan: Long-term plans covering an approximately ten-year period are established and ratified as guidelines outlining a country's goals for socioeconomic development. They are formulated in such a way that they do not need to be adjusted significantly in the event of changes in government administration or short-term economic conditions. Tanzania's "Vision 2025" and "Kenya's Plan to Eradicate Poverty" (fifteen-year plan) are good examples of long-term plans.

Long-term plans cover an approximately ten-year period.

Medium-term plan: Medium-term plans covering three to five-year periods are more detailed plans within the long-term plan. These plans consist of macroeconomic analysis and debt analysis, sector-specific policies and their priorities, and plans on how to use funds to best achieve these policies. Medium-term plans are generally formulated as rolling plans and are reflected in annual policy decisions and fiscal budget formulation. In addition, they are revised every year based on an assessment of the outcomes actually achieved and revenue estimates. PRSP and MTEF formulated in HIPCs are medium-term plans. Typically, these medium-term plans are established as guidelines not legally binding future spending.

Medium-term plans covering three to five-year periods are reflected in annual policies and fiscal budget formulation.

PRSP and MTEF: PRSPs are generally medium-term plans covering a three-year period. PRSP are a condition for receiving debt reliefe under the HIPC initiative, having been prepared by HIPC governments since the late 1990s. In some countries (for example, Tanzania) political efforts have been made to ensure that PRSP is consistent with existing long- and medium-term plans, whereas in other countries PRSP is the sole medium-term plan. MTEF outlining the revenue and financial requirement for the next three years is established to back up the PRSP with the necessary budget allocations. The MTEF is intended to allocate the rev-

MTEF is established to back up the PRSP with the necessary financial requirements.

Medium-term plans such as PRSP and MTEF serve as a guide in devising the annual budget.

enue the government expects to generate over the next three years consistent with PRSP policy priorities.

Formulation of PRSP, MTEF and annual budgets: Figure 3-4 shows the relationship between PRSP, MTEF and the annual budget. The medium-term plans (PRSP and MTEF), which include estimates for budget allocation, serve as a guide in devising the annual budget. To fulfill this role, the budget formulation process must include, at a minimum, the procedures outlined below.

- Medium-term plans are revised according to political conditions, macroeconomic conditions, indebtedness of government, and evaluation of policy outcomes

Box 3-5: Japan's medium to long-term plan and annual budget formulation schedule

Japan does not have a medium to long-term fiscal plan serving as a multi-year budget, but the "Structural Reform and Medium-term Economic and Fiscal Perspective," ratified by the Diet and revised every fiscal year, outlines the basic policies for Japan's economic and fiscal management over the medium term.

Japan's budget formulation schedule is shown below. Currently, the budget is formulated according to the Guidelines (set in June), but previously budget requests were made in August without the benefit of such Guidelines. However, realizing that this put the budget process in the hands of the bureaucracy and particularly the Ministry of Finance, the government began establishing the Guidelines for Budget Requests under the prime minister's leadership. Currently, the Council on Economic and Fiscal Policy prepares the Guidelines. These Guidelines can be improved, however, and in the future they should be more specific, set out policy priorities and quantitative goals and include a program chart.

Month	Budget formulation schedule
January	“Reform and Perspective” is established; Diet discusses budget draft
February	
March	Budget draft is established
April	New fiscal year starts
May	
June	Guidelines for next fiscal year is established
July	“Budget Overview” for next fiscal year is established
August	Budget requests for next fiscal year
September	
October	
November	
December	“Basic Budget Policy” is established Draft for tax system revisions in next fiscal year Budget draft for next fiscal year is determined

- Budget formulation guidelines (such as the budget ceiling) are established based on revisions to the medium-term plan
- The budget draft is established based on budget formulation guidelines
- Budget draft is approved and executed

It is important to notice that the medium-term plan needs to be revised and results of this revision need to be reflected in the guidelines for formulating the fiscal budget.

The PEFA indicator "PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting" states that the following aspects should be assessed:

(i) Preparation of multi-year fiscal forecasts and program allocations
(ii) Scope and frequency of debt sustainability analysis
(iii) Existence of sector strategies with multi-year costing of recurrent and investment expenditure
(iv) Linkages between investment budgets and forward expenditure estimates

PEFA PMF
PI-12 Multi-year perspective in fiscal planning, expenditure policy and budgeting.

This indicator is used to assess the quality of a country's medium-term policy with a focus on the existence of a MTEF, the relevance of the debt analysis it is based on, and the relevance of investment plans to implement sector strategies. However, opinions are divided on the effectiveness of MTEF, given that many developing countries cannot be certain of their revenue in the medium term due to their reliance on donors for much of their capital expenditures. It is also pointed out that the relationship between annual budget formulation and MTEF revisions is not usually well defined in budget procedures.

Opinions are divided on the effectiveness of MTEF as revenues from donors in the medium term are not predictable.

(b) Participation of legislature and ministries in formulating annual budget

In general, the executive branch of the government establishes a budget draft and submits it to the legislature. The budget is formulated in accordance with budget formulation guidelines reflecting the aforementioned medium-term plan and the political and economic environment. The budget can be compiled using both a top-down macro approach (defining government resources and priorities and setting sector spending ceilings accordingly) and a bottom-up micro approach (formulating and costing sector-level programs within sectoral spending limits). With this approach, sector-level government ministries submit budget requests based on their micro budgets, and then negotiate with the Ministry of Finance based on its own macro budget framework. In an assessment-and-negotiation process, the stakeholders eventually arrive at a budget draft. The budget is established in these steps:

During the budget formulation process many stakeholders are involved in budget assessment, and the negotiation process.

- Guidelines for formulating the budget are determined
- Ministry of Finance drafts macro budget

- Line ministries draft micro budgets
- Ministry of Finance and line ministries negotiate budget and formulate government budget proposal
- Legislature discusses and approves budget

The legislature, advisory committee, cabinet, etc. are involved in setting budget preparation guidelines.

Determination of guidelines for budget preparation: The legislature, advisory committee, cabinet, and finance ministry are all involved in setting the guidelines for budget preparation. These guidelines are based on public opinion and private-sector views as well as medium-term plans and the macroeconomic outlook. The guidelines determine priority policies and areas to be prioritized in budget allocation, in addition to the budget ceilings.

Ministry of Finance estimates revenues, and determines the outlines of sector allocation following the budget guidelines.

Macro budgeting by Ministry of Finance: The Ministry of Finance estimates tax revenue for the following year using the macroeconomic framework and tax revenue in previous years, and then determines the broad outlines of sector-level allocation in accordance with the budget guidelines. The ministry also prepares a revenue budget by reviewing the tax system and public bond issuance. This budget process is known as the macro, or top-down, approach. HIPCs would also consider financial resources from donors based on the results of PRSP monitoring.

Line ministries compile their micro budgets in accordance with the budget guidelines.

Micro budgeting by line ministries: In tandem with the finance ministry's macro budgeting, the line ministries begin to compile their micro budgets in accordance with the budget guidelines. The various ministry divisions prepare draft plans for their budget requests, the departments then assess the draft plans and incorporate these in their departmental draft budget requests. The line ministries' secretariats work with the departments to evaluate and negotiate to restore cuts in budget requests, finally concluding in the ministries' budget requests. This micro budget process starting at the lowest organizational units are the bottom-up approach.

Once all of the line ministries have submitted budget requests, the finance ministry negotiates with the line ministries.

Negotiation between Ministry of Finance and line ministries for formation of government's budget proposal: Once all of the line ministries have submitted their budget requests, the finance ministry reviews the budget estimates and negotiates with the line ministries. The government budget draft is compiled through repetition of this process.

Discussion and approval of budget by legislature: Once the government budget draft has been formulated, it is submitted to the legislature for deliberation. The public participates in this step via the legislature. The legislature typically approves the budget before the new fiscal year starts.

Box 3-6: Japan's budget formulation process

Box 3-4 outlines the schedule followed in formulating the budget, but what is the specific process? Japan's Ministry of Finance formulates a macro budget and the line ministries formulate micro budgets concurrently. Political parties, ministries and other interested parties adjust for each others' interests during the budget drafting process. This give-and-take tends to be carried out between the ruling party and the ministries during this drafting process rather than during the legislative process. Once the line ministries have submitted their budget requests to the Ministry of Finance in August, the ministries and the various divisions of the LDP's Policy Affairs Research Council coordinate the requests. During negotiations to restore budget cuts (the revival negotiations) the Policy Affairs Research Council provides industry groups with opportunities to make their own requests; the divisions assist the ministry relevant to the issue at hand. The ministries, facing political pressures, negotiate with the Ministry of Finance.

In this way, the negotiations important to Japan's budget drafting take place between the ruling party and the line ministries rather than in the legislature. Thus, it would appear that Japan meets the PEFA indicator "PI-11 Orderliness and participation in the annual budget process," but the reality is quite different. However, the prime minister has recently taken on a stronger role, and now the Council on Economic and Fiscal Policy, which falls under the direct jurisdiction of the prime minister, sets the guidelines for the next fiscal year. Accordingly, the budget is now simply filled in based on these guidelines, limiting the opportunities for compromise between the ruling party members and industry groups and line ministries. Criticism that this method reflects Prime Minister Junichiro Koizumi's disregard for ruling party members was likely instigated by their loss of an influential sphere of action.

The budget is theoretically established through these steps, but in reality the budget is generally negotiated among various stakeholders and interest groups before the legislative deliberations begin. For example, in Japan's case, representatives from industry and citizen groups appeal to the line ministries as they determine their draft budgets, and the line ministries negotiate with the finance ministry. The situation is the same for developing countries, but it is not easy for outsiders to understand the entire process. In this sense, while the legislative branch's deliberation of the budget draft is important, understanding the budget formulation process requires some attention to the process by which the budget is prepared within the government. It should be understood that in this context, donors also try to influence allocations of funds when budgets are discussed and negotiated in and between line ministries and the ministry of finance.

PEFA indicator "PI-11 Orderliness and participation in the annual budget process" should be assessed in terms of the following aspects:

Budget draft is submitted to the legislature for deliberation.

Budget is generally negotiated among various stakeholders and interest groups before the legislative deliberations begin.

PEFA PMF
PI-11 Orderliness and participation in the annual budget process.

Box 3-7: Budget deliberations in the Japanese parliament

Japan's parliament debates the budget for the following fiscal year from January through March every year. First, the government submits the budget to the Lower House. The process is as follows: financial policy speech in full session => questions from party representatives in Lower and Upper houses => explanation of intent (all in full Diet session until this point) => general budget deliberations (in budget committee from this point) => general questions => public hearing =>intensive deliberations => closing general budget deliberations => deliberations and vote in committee => deliberations and vote in full session (Atsushi Miyawaki, Zukai: Zaisei no shikumi [Graphic representation of fiscal structure], 1999).

This budget deliberation process would satisfy the PEFA indicator "PI-11 Orderliness and participation in the annual budget process." However, the reality is more problematic. For example, the budget itself is not discussed in the budget committee. As the most highly visible committee in the Diet, the budget committee tends to focus on attention-grabbing issues such as scandals rather than on finance. Any discussion of the budget tends to be limited to the general budget, with insufficient attention to special accounts and the government's fiscal investment and loan program. This is partly because, as described in Box 3-6, the special-interest wrangling has already occurred by the time the budget draft is prepared.

(i) Existence of and adherence to a fixed budget calendar
(ii) Clarity/comprehensiveness of and political involvement in the guidance on the preparation of budget submissions (budget circular or equivalent)
(iii) Timely budget approval by the legislature or similarly mandated body

It is important that budget information is shared within organizations.

In addition, it is important that budget information is shared within organizations. In developing countries, organizations often fail to share this practical information among them, indicating serious problems with the organizations' internal control and audit functions. In addition, the media's involvement in the budgeting process is very important in opening the budget process up to the public.

Zambia's budget schedule is chronically delayed.

Zambia's budget schedule is chronically delayed. Zambia customarily formulates its budget in July and is invariably forced to run its administration on an interim budget when the new fiscal year starts in January. The UK has similar chronic delays. However, it may not be a significant issue if administration carries out its activities according to this expected delay. In some countries, information on the working budget is only circulated among a few at the top levels of governmental organizations (as in Kenya).

3-4-4 Management of budget execution process

(1) Execution of revenue budget

Execution of the revenue budget is heavily dependent on external factors such as the economic environment. Further, tax revenues are also influenced by whether the tax system is run well and taxpayers are conscientious about their obligations, and by the efficiency of the tax collection system. The government must work to improve these aspects. In this section, we will explain how a government can go about (a) clear tax system and improvement of taxpayer compliance, (b) efficient tax collection, and (c) securing revenue from sources other than taxes.

Execution of the revenue budget is heavily dependent on external and internal factors, such as efficiency of tax collection systems.

(a) Clear tax system and improvement of taxpayer compliance

In public finance, the clarity of the tax system such as tax law, the taxpaying environment and taxpayer compliance, and the administrative review or public appeal process against administrative decisions that guarantees an equitable tax system are all crucial to the government's ability to collect revenue.

Clear and comprehensive taxation: The tax system is based on the government's ability to efficiently collect taxes from its citizens. While the success of this depends on the compliance of the taxpayers themselves, tax law must clearly and comprehensively regulate the method by which tax liabilities are calculated and the means by which taxes can be collected. This ensures that tax officers and tax collectors do not arbitrarily collect taxes. Therefore, a good tax system must be transparent.

To prevent arbitrary tax collection, tax law must clearly and comprehensively regulate taxation methods.

Development of tax payment system and improvement of taxpayer awareness: Measures are introduced to raise taxpayer awareness. In Japan, children are taught in school about tax obligations, while the system of deducting income taxes at the source, in which the employer is required to collect part of the income tax due on his employees' earned income[25], is intended to heighten taxpayer awareness and improve the efficiency of tax collection. In many countries, individuals are required to file their own income taxes (as in the US). This makes it all the more important that taxpayers are educated about their obligations, and that the infrastructure is set up to facilitate tax payments (such as tax law, easy access to tax forms, simple methods for calculating taxes, availability of assistance with tax payments, etc.).

Measures are introduced to raise taxpayer awareness, and to facilitate tax payments.

[25] This system whereby income taxes are deducted directly from the employee's earned income was introduced to improve Japan's finances in 1941 as part of the government's efforts to increase revenue.

Tax appeals mechanism should be independent, fair, functional, and easy for taxpayers to access.

Administrative review: Taxpayers must be able to contest their tax liabilities and tax assessment methods through an administrative review process. This ensures that the tax system is equitable and transparent. This tax appeals mechanism should be independent, fair, functional, and easy for taxpayers to access.

PEFA PMF
PI-13 Transparency of taxpayer obligations and liabilities.

PEFA indicator "PI-13 Transparency of taxpayer obligations and liabilities" assesses the clarity of a country's tax system and taxpayer compliance. This indicator assesses the following.

(b) Efficient tax collection

Effectiveness of tax systems with an efficient tax collection should be guaranteed.

In addition to maintaining a clear tax system, countries must be able to guarantee the effectiveness of their tax systems with an efficient tax collection. This is a crucial element in building the foundation for revenue in public finance. Tax collection institutions such as the revenue agency, tax collecting agency, and customs authority must be able to identify taxpayers, accurately assess their tax liabilities, monitor for tax evasion and impose effective penalties as needed.

The first step in imposing and collecting taxes is identifying taxpayers and managing the records.

Management of taxpayer records: The first step in imposing and collecting taxes is identifying taxpayers and managing the records. Taking advantage of records collected by other agencies for other purposes (such as business records, records of bank accounts opened, pension registration) improves the efficiency of this process. Also, the tax authorities can confirm correct tax payments by conducting spot checks.

Identifying illegal acts and imposing strict and fair penalties is crucial in operating tax system.

Identification of illegal acts such as tax evasion and imposition of penalties: Identifying illegal acts such as tax evasion and imposing strict and fair penalties is crucial in operating a tax system. Ignoring tax evasion and failing to take action to address taxpayers' concerns for fair taxation can discourage their willingness to comply with tax regulations and potentially weaken the tax system. Tax evasion can be identified with tax audits that focus on particularly risky sectors and taxpayer groups. Tax evasion and other illegal activity involving taxpayers and tax collectors should be addressed by ensuring that the tax collection agency has the ability to control and audit itself.

Delays in tax collection reduce the government's ability to implement the budget and thus influences the overall reliability of PFM.

Effective tax collection: Delays in tax collection by a revenue agency and condoning late tax payments reduces the government's ability to implement the budget and also reduces the reliability of the tax system. This can lead to major problems in the effectiveness of public financial management. Delays in tax collection and payment often lie in the identification of a large number of new taxpayers or a large number of tax cases being contested. The amount of tax liabilities in dispute must be deducted from the revenue estimates. Further, an efficient tax collection system must involve the speedy deposit of tax payments in the national treasury.

Review of taxable items: Collecting taxes on some items can incur extremely large transaction costs and prevent fair tax collection. Further, the cost of tax collection for some items can be higher than the amount collected. In these cases, it should be necessary to revise methods used to assess and collect taxes for such items.

Tax items and methods with high transaction costs should be revised.

PEFA has three indicators assessing the efficiency of a country's tax collection: "PI-13 Transparency of taxpayer obligations and liabilities," "PI-14 Effectiveness of measures for taxpayer registration and tax system," and "PI-15 Effectiveness in collection of tax payments."

PEFA PMF
PI-13 Transparency of taxpayer obligations and liabilities.
PI-14 Effectiveness of measures for taxpayer registration and tax system.
PI-15 Effectiveness in collection of tax payments.

To provide one example, the government of Ethiopia with the help of the IMF and World Bank succeeded in raising the ratio of estimated to actual revenue to 95 to 105% by introducing taxpayer identification numbers, running campaigns to improve taxpayer compliance, and improving government's capacity to monitor tax evasion. Tanzania made its tax collection agency a public corporation (Revenue Authority) in the 1990s to improve the efficiency of its tax collection, and has reported that its tax revenue has increased.

(c) Securing revenue from sources other than taxes

Governments can also generate income from sources other than taxes, including revenue from public corporations as well as revenue from selling concessions for harvesting timber and developing mines, issuing public bonds and borrowing capital from the financial market. Financial markets must be developed to the point that they can supply the government with large sums of money at low interest rates when it issues public bonds and otherwise raises money in financial markets. Although PEFA does not have an indicator to assess a government's ability to acquire revenue from sources other than taxes, the ability should be assessed accordingly, because it is common in many developing countries to secure funds by borrowing from domestic financial markets and donors' foreign-currency loans.

Governments also generate income from non-tax sources including revenue from public corporations, forest concessions, public bonds, borrowings, etc.

The government of Malawi was unable to secure sufficient revenue from donors alone, and was forced to raise the money needed for government spending in the domestic financial market at extremely high interest rates. With respect to this example, it should be noted that the HIPC initiative was launched because HIPCs defaulted on their foreign currency loans from donors, and thus developing countries should be cautious about raising money from sources other than taxes.

The government of Malawi was forced to raise money in the domestic financial market at extremely high interest rates.

Box 3-8: Problems in Japan's tax system

Japan faces severe fiscal difficulties, making it all the more important that it increase its tax revenue. Raising the income and corporate tax rates is not a viable option as it would hurt economic competitiveness, while taxes themselves are susceptible to economic fluctuations. This would make raising the consumption tax -- an indirect tax -- the best option. The government would undoubtedly prefer to raise the consumption tax, which can be collected efficiently and offers a way for the government to generate tax revenue that is not subject to economic fluctuations. However, this kind of non-progressive tax hits low income people the hardest, and politicians will recall that the Takeshita cabinet was forced to resign after introducing the consumption tax, and that the Hashimoto cabinet also resigned after the economy contracted when the consumption tax rate was raised in 1997. If the past is any guide, then, politicians will have a hard time raising consumption taxes.

Japan must also overhaul its special taxation measures, which would also increase the government's revenue. These special taxation measures, which include special exemptions for spouses, exemptions for housing loans, and special rates to encourage companies to reduce non-performing loans, in essence removes income that would otherwise be taxed and makes it exempt for policy reasons. These taxation measures are intended to back a particular policy and should thus be short-term policies. Unfortunately, the beneficiaries of these measures fight to protect their interests, making it very difficult to abolish such measures once they have been introduced. Further, the vested interests created by special taxation measures impair the clarity of the tax system.

(2) Execution of expenditure budget

Budget execution in the budget cycle has a number of issues which are not easy to address effectively.

Effective execution of the expenditure budget has a significant impact on outcomes of policies implemented. Budget execution in the budget cycle has a number of issues which are not easy to address effectively. Fraud and corruption are most likely to occur in the execution process, as are budget management problems such as over-commitment of expenditures. These problems can be managed by elevating ethics and reinforcing internal controls, a subject to be discussed in the next section. In this section, (a) management of the expenditure cycle and adjustment, (b) cash and debt management, (c) payroll management, (d) procurement, and (e) settlement of accounts will be addressed.

A sound monitoring and reporting function is needed for flexible and efficient budget management.

(a) Management of the expenditure cycle and adjustment

While budgets must be executed in accordance with the budget approved by the legislature, appropriations of funds often need to change in response to the macroeconomic environment. In other words, a sound monitoring and reporting function which is able to identify issues in execution is needed for a flexible and efficient budget management. In addition, goods and services should be procured efficiently and effectively during the execution process.

Meeting such multi-faceted demands requires that the fiscal year be one year in duration and that the expenditure cycle be closely managed, while allowing for some flexibility in adjusting allocations in accordance with the regulations.

Fiscal year and its independence: In public financial management, the fiscal year is generally one year in duration (the exceptions are state budgets in the US and the UN budget, which cover a two-year period). Countries end their fiscal years at different times of the year, with the fiscal year running from January through December, in Ghana, Zambia, Senegal, Burkina Faso, Madagascar, Mozambique and France, April through March in Japan and the UK, July through June in Uganda, Ethiopia, Tanzania and Malawi, and October through September in the US, for example.

In public financial management, the fiscal year is generally one year in duration.

In principle, budgets cannot be used before the relevant fiscal year has started or once it has ended. This principle is referred to as the independence of the fiscal year, and stipulates that the expenditures of each fiscal year shall be appropriated with the revenues of the same fiscal year. Increasing expenditures for that fiscal year under the assumption that revenues will be higher in the following fiscal year would create a sense of ambiguity that could lead to lax financial policy. On the other hand, overly rigid adherence to the independence of the fiscal year impedes smooth and flexible budget execution. Accordingly, an exception has been built into this principle, allowing for expenditure budgets to be carried over.

Budgets cannot be used before the relevant fiscal year has started or once it has ended.

Expenditure cycle: Figure 3-5 provides an overview of the standard expenditure cycle. The budget is executed in accordance with the expenditure cycle described below. Cash needed for payments is managed using separate methods (refer to "(b) Cash and liability management" for more information).

There are exceptions for budgets to be carried over to next fiscal year.

(i) Appropriation: Legislature approves budget.

(ii) Apportionment and allotment: Once the budget has been established, the executive branch is given the authority to execute the budget. The budget is allocated to the heads of government ministries and agencies as stipulated through notification of cash limits, issue of warrants, fund transfers to imprest accounts, etc.

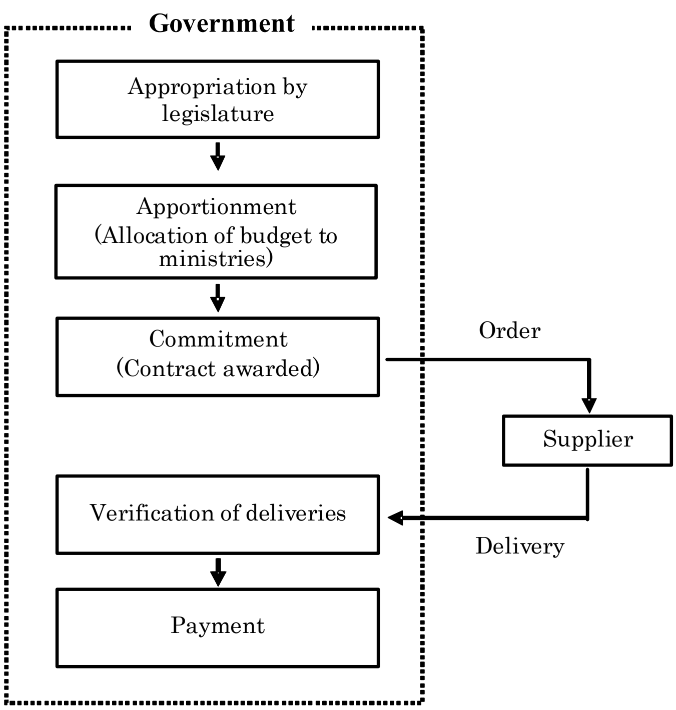
(iii) Commitment: When the government commits itself to certain expenditures, it concludes contracts requiring them to make future payments.

The government is required to pay when the contractor fulfills the terms of the contract[26].

At this point, the government must confirm that the relevant funds have been allocated in the budget and that there are enough remaining funds to cover this expenditure, and must also check that commitment corresponds to the budget and was approved by the proper authority.

(iv) Verification of deliveries: The government confirms that goods and services have been delivered in accordance with the terms of the contract. Once this has been confirmed, under the accrual method of accounting, the government records the commodity as an asset and records an increase in liability owed to contractor (refer to "3-4-5 Accounting and reporting" for more information). Under cash-basd accounting these expenses are recognized when the cash is paid.

Documentation verifying the receipt of goods and services must be confirmed at this point. Before payments are made, the government must confirm that the contractual obligations are legally valid, that experts verified the delivery of goods and services, invoices have been written cor-



Source: Asian Development Bank (1999)

Figure 3-5 Expenditure cycle

[26] However, in strict terms, payment obligations are defined differently according to a country's budget system and the economic category that the expenditure falls under.

rectly and the creditor is accurate.

(v) Payment: Once the delivery of goods and services has been verified, payment is made after the stipulated procedures have been followed. Payments may take the form of a check, cash or electronic transfer. Payment using a check is recorded when the check is issued.

After payment, audits must be performed to confirm proper payment and the absence of fraud (refer to the sections on internal audits and external audits for more information).

Virement: Budgets may be given greater flexibility by transferring amounts from one budget heading to another. Under most finance laws, there are two types of virement: transfers that the line ministries can make under their own authority and transfers that require approval from the finance ministry. Other transfers are forbidden. As arbitrary transfers could weaken the budget's ability to maintain fiscal discipline and lower budget credibility, the need for any transfer must be duly considered. In particular, transfers that would effect the execution of the policies approved by the legislature should be avoided. Governments in developing countries will sometimes limit transfers to other line items so that personnel costs cannot be cut without careful consideration, or in the reverse situation, they will limit transfers from other line items to prevent personnel costs from increasing without control.

Budgets may be given greater flexibility by transferring amounts from one budget heading to another.

PEFA indicator "PI-16 Predictability in the availability of funds for commitment of expenditures" assesses a country's management of the expenditure cycle and adjustments to budget allocations. The indicator evaluates expenditure commitments and capacity of cashflow management to make payments. Governments cannot receive a high score on this indicator unless all parts of the budget execution function properly. Developing countries may commit to expenditures without considering whether the budget is appropriated and funds are available, leading to delays in paying suppliers and chronic debt. This could be prevented if the ministry of finance were to regularly compile information and adjust the expenditure process throughout the fiscal year to ensure that expenditure commitments and payments are systematic.

PEFA PMF
PI-16 Predictability in the availability of funds for commitment of expenditures.

(b) Cash and debt management (role of treasury)

Cash management, and debt guarantee and management are crucial aspects of budget management. In this case, debts refer not only to foreign currency loans from donors, but also to short-term loans made from the domestic capital market that the government uses to supplement its cashflow. In some cases, this cash is

Cash management, and debt guarantee and management done by treasury are crucial aspects of budget management.

managed and monitored in an account set up in the central bank's treasury, and in other cases, it is managed in a bank account (sometimes opened in a commercial bank) held by the ministry, department or agency (MDA) making the expenditure. In the latter case, the finance ministry must compile cash reports to ensure proper management.

Ensuring that payments are made in accordance with the budget requires not only information on cash expenditures, but also information that MDAs submited expenditure commitment and payment plans to the finance ministry or other revenue administration (RA). The finance ministry authorizes the MDA plans to facilitate expenditures from the treasury, and gives due consideration to the treasury's funds, revenue and the government's general financial condition.

Government's cashflow management is important because revenue from taxes and other sources, and government payments fluctuate throughout the year.

Revenue from taxes and other sources, and government payments fluctuate throughout the year. Tax collections might increase when firms settle their books at the end of their financial year, and government spending often increases at the end of the fiscal year, when contract periods tend to expire, or when the government buys up agricultural products to control prices. The government must take measures to ensure that payments are not delayed due to these fluctuations, and that it invests surplus capital for profit and minimizes the cost of interest on its loans. In developing countries, central banks must access the foreign currency market to receive foreign currency loans from donors, repay their debts and pay export and import costs. In addition, they must recalculate government revenue projections in the middle of the fiscal year and, in some cases, formulate a supplementary budget. This demonstrates the importance of a country's financial and cashflow management.

Managing a large amount of government funds has an impact on the financial market.

Managing a large amount of government funds inevitably has an impact on the financial market. In government fund transactions with the public, cash outflows from the treasury increases the amount of money in circulation and eases monetary conditions (e.g. the interest rates on bank loans decrease). Conversely, when money goes into the treasury, the amount of money in circulation decreases and monetary conditions are tightened. Since the government takes advantage of this treasury function to carry out macroeconomic policies[27], success depends on the treasury managing the funds under its control.

PEFA PMF
PI-17 Recording and management of cash balances, debt and guarantees.

The PEFA indicator "PI-17 Recording and management of cash balances, debt and guarantees" assesses the government's ability to manage its cash and

[27] Not only can treasury functions be used for the government's macroeconomic policies, but the central bank can use its independent position to carry out monetary policy in the interest of stabilizing the economy.

debt. For example, technical assistance to Ghana's finance ministry funded by JBIC[28] revealed that the division responsible for debt management faced many issues. The project recommended improvements in the flow of debt information from the MDAs to the ministry of finance. It also suggested that strengthening management and analyses of debt information by the ministry of finance, in fact, should facilitate the smooth flow of accurate debt information to budget divisions and back to MDAs responsible for projects financed by debts.

(c) Payroll management

Typically, a payroll of government employees is the largest expenditure in developing countries, and is also at the center of cost management and corruption issues.

A payroll of government employees is the largest expenditure with issues to be addressed.

Many countries prohibit virements (transfers) to cover personnel costs in order to prevent a payroll from increasing without control. These costs are managed using a salary payroll prepared for each employee, making it essential that changes in employee records are reflected in the salary payroll in a timely manner, and that the actual amount paid is the same as the amount recorded in the payroll. For this reason, the payroll should be audited regularly, and ghost workers as well as payment mistakes should be addressed.

Payroll should be audited regularly to prevent it from increasing without control.

PEFA indicator "PI-18 Effectiveness of payroll controls" can be used to assess the following dimensions of payroll control:

PEFA PMF
PI-18 Effectiveness of payroll controls.

(i) Degree of integration and reconciliation between personnel records and payroll data
(ii) Timeliness of changes to personnel records and the payroll
(iii) Internal controls of changes to personnel records and the payroll
(iv) Existence of payroll audits to identify control weaknesses and/or ghost workers

(d) Procurement

A large portion of the government budget is spent for public procurement. Well-functioning procurement operations that are transparent and fair are the key to using money effectively and efficiently. The procurement process can lend itself to corruption and collusion. Fraud should be minimized with mutual oversight between all stakeholders involved in procurement, monitoring by the public and auditing organizations, and appropriate procurement practices. Fraud in developing

Procurement is the key to using money effectively, at the same time it can lend itself to corruption and collusion.

[28] Japan Bank of International Cooperation, *Republic of Ghana -- Kokyozaiseikanri shien ni kakaru enjokoka sokushin chosa*

countries prevents public resources from being used effectively.

Procurement should be monitored closely to ensure proper procedure and the absence of fraud.

Procurement usually follows the steps outlined below. The process should be monitored closely at every step to ensure proper procedure and the absence of fraud.

(i) Preparation of specifications and terms of references: Alternative proposals, possibilities for procuring goods and services, and procurement methods are reviewed.

(ii) Selection of procurement method and procedures: Regulations related to the tender method (international tender, national tender, private contract, technical proposal method, etc.), and international treaty frameworks (such as WTO) must all be considered. In some cases, donors designate a specific tender method for a project funded by them.

(iii) Winning bidder is chosen through competitive tender: Tender participants can be limited by a long or short list of bidders based on a prior screening of qualifications. The winning bidder is chosen after an evaluation of price, quality and technical competence. The agency procuring the goods or service decides whether to emphasize price or technical competence based on the nature of goods and services to be procured.

PEFA PMF
PI-19 Competition, value for money and controls in procurement.

PEFA indicator "PI-19 Competition, value for money and controls in procurement" assesses the procurement process. PEFA recommends that this indicator be assessed based on the following dimensions: (i) percentage of contracts awarded in open competition; (ii) justification for use of less competitive procurement methods; and (iii) existence and operation of a procurement complaints mechanism.

The World Bank's CPAR analyzes procurement in developing countries and identifies issues affecting it.

The World Bank's Country Procurement Assessment Report (CPAR) analyzes procurement in developing countries and identifies issues affecting the procurement process in these countries. For example, the CPARs for Tanzania, Ghana, and Ethiopia point out that the procurement process is arbitrary and corrupted, and lacks transparency. In many of the surveyed countries (Uganda, Tanzania, Ghana, Zambia, Mozambique, Burkina Faso, and Ethiopia), reforms in procurement systems and organizations are underway as a part of PFM reform with support from donors.

In Tanzania, the reform of procurement organizations is underway.

For example, in Tanzania, Central Tender Board, which conducted public procurement, has been transformed to Public Procurement Authority whose responsibility is to supervise the procurement process carried out by ministries. In this case, procurement authority has been decentralized to line ministries to achieve timeliness, appropriateness, and efficiency of procurement operations while securing accountability of the operations.

(e) Settlement of accounts

Once the budget has been executed for a single fiscal year, the ministries, departments or agencies (MDAs) prepare financial statements for their revenue and expenditures and submit them to the finance ministry by a pre-determined date in the following fiscal year. The finance ministry bases its final financial statements on these reports, and submits them to the auditing board by following the necessary procedures. After the audit is completed, the financial statements are submitted together with the audit report to the legislature for approval.

Financial statements are prepared by finance ministry, audited by the audit board, and submitted to the legislature for approval.

Adjusting for budget excess and shortfalls: Governments may find that they have excess or deficient revenue when executing the budget. Surpluses are typically transferred to revenue for the following fiscal year after the amount has been confirmed during settlement. Revenue shortfalls can be covered by virements or allotting emergency funds. If this is not sufficient to cover the shortfall, a special adjustment budget appropriated for settlement will be used or supplementary budget will be prepared for approval. If revenue shortfalls are caused by temporary cash positions attributable to a time lag between expenditures and revenue, funds can be obtained from a temporary transfer from the treasury or a temporary loan from the central bank.

Budget surpluses are typically transferred to revenue for the following fiscal year, and shortfalls can be covered by virements or allotting emergency funds.

(3) Internal control and internal audit

Internal control: Internal control plays a crucial role in implementing policies through excution of the budget. Internal control performs the following functions:

Internal control plays a crucial role in implementing policies through excution of the budget.

(i) Economical, efficient, and effective achievement of the entity's objectives
(ii) Adherence to external rules (laws, regulations, etc.) and to management policies
(iii) Safeguarding of assets and information
(iv) Prevention and detection of fraud and error
(v) Quality of accounting records and timely production of reliable financial and management information

These functions can be achieved by adopting management practices that ensure budget execution and policy assessments are appropriate. Although management practices differ depending on the institution's function, general practices can be summarized as follows:

(i) Establishment of financial accounting and financial reporting systems (including management of debt, salary and advance payments)
(ii) Performance monitoring and evaluation of expenditure and outcome
(iii) Communication that ensures the organization's goals and values are shared
(iv) Control of access to the organization's assets and information
(v) Management of decision-making process
(vi) Management of procurement process
(vii) Separation of duties with high risk (for example, duties of money collection, receipt of money, deposit of money, and confirmation of bank records should be performed by different individuals)

Internal audit is the oversight over internal control system.

Internal audit: Internal audit refers to the oversight provided by an independent division set up within an organization covering the internal control system, as described above. Accordingly, internal audit is responsible not only for accounting audits, but also for ensuring that the control mechanisms essential for proper management of the organization are functioning.

PEFA PMF
PI-20 Effectiveness of internal controls for non-salary expenditure.

PEFA indicator "PI-20 Effectiveness of internal controls for non-salary expenditure" assesses the effectiveness of expenditure commitment controls, the comprehensiveness, relevance and understanding of other internal control rules and procedures, and the degree of compliance with rules for processing and recording transactions. PEFA recommends that this indicator be used to evaluate the development status of internal controls.

PEFA PMF
PI-21 Effectiveness of internal audit.

"PI-21 Effectiveness of internal audit" assess the coverage and quality of the internal audit function, and the extent of the management response to internal audit findings. This indicator should be used to assess the level of internal audits.

3-4-5 Accounting and reporting

(1) Accounting practices

Although accounting practices are basic techniques, the entire organization must rigorously apply these practices to be effective.

For successful IFMIS introduction, the accounting system must be functional.

Budget management is conducted based on accurate information collected and compiled by accounting. Although accounting practices are basic techniques, the entire organization must rigorously apply these practices to be effective. In developing countries, accountants and other qualified professionals tend to work in the private sector, leaving a marked shortage in the government sector. The Integrated Financial Management Information System (IFMIS) was adopted in some developing countries, but the accounting system -- whether it be cash-based or accrual-based accounting -- must be functional for it to be successful. This section will discuss (a) cash-based accounting and accrual-based accounting and (b) accounting and IFMIS.

(a) Cash-based accounting and accrual-based accounting

Administrative management theories in New Public Management (NPM) attempt to apply corporate management concepts to the public sector. It recommends that accrual-based accounting, typically used in corporate accounting, be introduced in the public sector to replace the cash-based accounting which is widely used in the public sector. However, this is not always advisable, and depends on the functions that the public sector is required to perform. If cash-based accounting is used appropriately, it is equally well-suited to ensure that public goods and services are provided. However, a number of developing countries have serious difficulties in even using cash-based accounting properly.

Although NPM recommends accrual-based accounting to be adopted in the public sector, developing countries still have issues operating cash-based accounting.

Cash-based accounting can be seen as a sub-set of accrual-based accounting. Simply put, in cash-based accounting transactions are not recognized until money is paid or received. In accrual-based accounting in addition to income and expenses, assets (buildings, inventory, accounts receivable, and bank accounts all fall under this category) and liabilities (loans, accounts payable, salary arrears, outstanding fees, unpaid contractual obligations all fall under this category) are recognized. In addition to dynamic transactions such as income and expenses, the relationship between assets, liabilities and capital at a specific point in time is expressed as "assets = liabilities + capital." This equation is used to relate between cash, assets and other various account items. Companies compare this equation at the beginning and end of the financial year to see increase or decrease in assets and liabilities. The increase over this period is the profit, or the difference between sales and expenses.

Cash-based accounting recognizes transactions when money is paid or received.

In accrual-based accounting, costs can be more accurately calculated. For example, if the government spent 500 million yen to construct a building, under cash-based accounting the government would record the 500 million yen in construction costs as an expense, whereas accrual-based accounting bank deposits under the asset category would decline by 500 million yen and real estate assets would increase by the same million yen, so there would be no change in the overall asset total before and after the transaction. The costs would not consist solely of the 500 million yen in construction costs, but 10 million yen in depreciation expenses incurred over the one-year period (one year over the fifty-year life of the building). In this way, accrual-based accounting gives a more accurate picture of costs. Because administrative costs in the public sector should be calculated as accurately as in private-sector companies it is recommended that accrual-based

In accrual-based accounting, costs can be more accurately calculated.

accounting should be adopted.

Whether adopting cash-based accounting or accrual-based accounting, it is essential to use either method properly.

Whether adopting cash-based accounting or accrual-based accounting, it is essential to use and manage either method properly and efficiently. For example, in order to introduce accrual-based accounting to an organization run by cash-based accounting, information of fixed assets, account payable, account receivable, etc. will have to be added and integrated. This indicates that if cash-based accounting is not properly implemented, introduction of accrual-based accounting is not realistic. Furthermore, differences in these account techniques are not only technical, but also reflect cost-oriented organizational culture and behaviors. Therefore, introduction of accrual-based accounting should be implemented in the context of comprehensive organizational reforms. From this point of view, there is no urgent reason for HIPCs to introduce accrual-based accounting. Instead, it is important to improve the operation of cash-based accounting. In Kenya for example, the government used accrual-based accounting until 2000. Because this accounting method often permitted government to incur expenditure commitments without securing budget to finance them, cash-based accounting was re-introduced in 2000.

(b) Accounting and IFMIS

Accounting ensures that reliable financial information is provided in a timely manner.

Accounting ensures that reliable financial information is provided in a timely manner with regular confirmation of income and expenditures, and the use of supporting documents to verify transactions. This function is extremely important for the organization to secure internal and external accountability.

Accounting includes two important types of reconciliation.

Accounting covers the entire process from recording of transactions to preparation of financial statements, and includes two particularly important types of reconciliation. The first is bank reconciliation, in which accounting data held in the government's books is reconciled with government bank account data held by central and commercial banks in such a way that no material differences are left unexplained. The second type is clearing and reconciliation of advances using supporting documents.

A common problem in developing countries is inadequate collection of accounting information.

A common problem in developing countries is inadequate collection of accounting information regarding public services provided to citizens. For example, schools and daycare centers do not submit accounting information on subsidy payments and procurement and supply of materials to the accounting system of the central government. This prevents the government from verifying that the provision of commodities and services is really carried out in accordance with the budget. This problem could become more serious as local governments are given more authority in the context of decentralization in developing countries.

In the 1990s, donors assisted many developing countries in introducing IFMIS, which requires the use of computers. It was assumed that introducing this information system would enable governments to capture financial data adequately and would thus reduce corruption. So far, the results have been mixed, with some countries having considerable success with this system and others experiencing failure. The following lessons need to be learned from these attempts:

It was expected that introducing IFMIS would enable governments to capture financial data adequately. However, results have been mixed.

(i) The human element -- people who manage the system -- needs to be given sufficient consideration
(ii) The development of affordable, easily managed, and user-friendly applications needs to be prioritized
(iii) Since the various government departments adopted systems with different specifications without coordination, developing a larger, more integrated system will be expensive and technically difficult
(iv) Sufficient time needs to be given introducing the system
(v) Corruption can take on new forms adapted for computerization

PEFA indicator "PI-22 Timeliness and regularity of accounts reconciliation" assesses the regularity of bank reconciliations and clearance of suspense accounts and advances. "PI-23 Availability of information on resources received by service delivery units assesses the collection of account information from service delivery units.

PEFA PMF
PI-22 Timeliness and regularity of accounts reconciliation.
PI-23 Availability of information on resources received by service delivery units.

In Burkina Faso, IFMIS was introduced fairly smoothly. The Treasury's system is able to collect accounting information on expenditures from branch offices of the central government in local authorities in a timely manger. This enables the central government to monitor situations in which a sector's budget execution rate falls to 50% due to the local branch's inability to procure goods, as well as the limited capacities of contractors in the private sector. The introduction of IFMIS in Ghana on the other hand, was not considered a success[29]. In Uganda, the system is gradually being expanded to cover more ministries and government agencies.

In Burkina Faso, IFMIS was introduced fairly smoothly.

(2) Accounting report

An accounting report is intended to provide information needed in the decision-making for efficient operations of activities, and to generate records on the budget's execution. After the end of the fiscal year the records are compiled to settlement information for the purpose of meeting requirements of transparency and accountability toward the legislature and citizens. This section will discuss (a)

An accounting report is intended to provide information for decision-making, and to generate the budget's execution records.

[29] World Bank, PFMTAP Implementation Completion Report.

budget execution progress reports and (b) financial reports.

(a) Budget execution progress reports

Regular progress reports on budget execution are essential for effective budget control.

Regular progress reports on budget execution are essential for effective budget control. In addition to amounts released by the finance ministry to the line ministries, these reports include detailed information on the budget status such as the balance of payment commitments and payments made. The reports include information on budgets implemented by local administration as well as information on the budget execution of the central government.

The precise status of budgets is accurately captured and information is integrated rapidly.

The finance ministry consolidates the reports received from the line ministries on the status of their budget execution to generate the government's overall report. In some countries, the ministry of finance (treasury) controls all of the accounting data and prepares the government report. An important requirement is that the precise status of budgets is accurately captured and information is integrated rapidly. This enables the government to promptly address current budget execution problems, thus lowering the costs associated with a delayed response. For this reason introducing IFMIS to obatain management information for timely decision-making would be advantageous.

PEFA PMF
PI-24 Quality and timeliness of in-year budget reports.

PEFA indicator "PI-24 Quality and timeliness of in-year budget reports" assesses the compatibility between the budget and the report's scope and structure, and the timeliness and accuracy of accounting information. Many developing countries need to improve in rapidly and regularly reporting accounting information.

(b) Financial report

A financial report needs to be prepared based on detailed and accurate information in a timely manner.

Preparing a financial report, including financial statements, is extremely important in ensuring the transparency and accountability of public financial management. A financial report will not be complete unless it is based on detailed and accurate information from all government divisions. The ability to prepare financial statements in a timely fashion is a key indicator of how well the accounting system is operating and the quality of the records maintained. As with the preparation of the budget execution reports discussed above, in a more centralized system the ministry of finance prepares all financial reports, while under a more decentralized system the line ministries issue financial statements that are then consolidated by the finance ministry. The final report is certified by an external auditor (refer to the next chapter) and submitted to the legislature.

It is important that financial reports are written with laypersons in mind.

Financial statements must be in accordance with international accounting standards or with other standards that the government has introduced.

PEFA indicator "PI-25 Quality and timeliness of annual financial statements" assesses the completeness and the timeliness of submission of the financial statements (ideally, six months after the fiscal year ends), and use of international accounting standards. In Japan, financial statements certified by the Board of Audit are submitted to the Diet seven months after the fiscal year ends. In developing countries, there are delays in submitting financial statements to the legislature. In 2004, Senegal submitted its financial reports five years late, Mozambique more than 20 months late, and Burkina Faso more than 12 months late.

Financial reports need to be written with laypersons in mind.

PEFA PMF
PI-25 Quality and timeliness of annual financial statements.

3-4-6 External audit and oversight by legislature

(1) External audit

External audit confirm whether administrative bodies implemented budgets effectively and efficiently in accordance with the laws, and have achieved the policy objectives. Further, financial management must be transparent to function properly. When an external audit uncovers evidence of illegal activity or waste, the auditing board advises the legislature on ways to redress these issues. The following section discusses (a) external audits by the audit board and (b) fiduciary risk and corruption.

External audits confirm whether administrative bodies implemented budgets in accordance with the laws, and have achieved the policy objectives.

(a) External audits by audit board

The fairness and quality of external audits on administrative bodies' financial reports is extremely important to secure the transparency and accountability of public funds. Accordingly, audit boards must be independent of the government administration to facilitate fair and independent judgment.

Audit boards must be independent from government administration to secure fair and independent judgment.

The scope of the audit should include budgetary and extra-budgetary funds, and autonomous agencies to secure a comprehensive audit. Further, while the audit board personnel and capacities must be maintained, limited capacities can be most efficiently used by focusing audits on the organizations representing the most risk. Also, narrowing the focus to important areas of financial management such as internal controls and procurement enables audit boards to use their resources effectively.

The scope of the audit should include budgetary and extra-budgetary funds, and autonomous agencies to secure a comprehensive audit.

It is crucial that governments follow up on the problems indicated by the audit board. The audit board's recommendations can be given greater weight by mandat-

Governments must follow up on the problems indicated by the audit board.

ing that the audited organizations submit an official letter to the legislature outlining the measures they have taken to redress the problems indicated in the audit.

PEFA PMF
PI-26 Scope, nature and follow-up of external audit.

PEFA indicator "PI-26 Scope, nature and follow-up of external audit" assesses the scope and nature of the audit performed, adherence to international auditing standards, timeliness of submission of audit reports to legislature and evidence of follow-up on audit recommendations.

In Tanzania and Mozambique, the audit boards have not been given adequate independence from government administration.

In Tanzania and Mozambique, the audit boards supposed to be responsible only to the legislature have not been given adequate independence from government administration. In Burkina Faso, Kenya and Mozambique, audits tend to be delayed and audit reports are not submitted to the legislature in a timely manner (see previous section). Audit boards often suffer from chronic personnel shortages, with qualified accountants prefering the private sector where working conditions are better.

Box 3-9: Board of Audit of Japan

The Board of Audit of Japan is an independent organization belonging to neither the legislative, executive nor the judicial branch of the government. Some observers are of the opinion that the Board of Audit properly belongs within the Diet as Japan has a parliamentary system of government and the Diet has budget authority. The PEFA indicator states the audit board should be independent of the government administration, not the legislative body.

The issue in question is the effectiveness of the audit. There is an unspoken rule in the Kasumigaseki district (the locus of government bureaucracy in Japan) that the audit report does not have to mention irregularities and problems discovered by the Board of Audit, if the ministry in question refuses to acknowledge them (according to an account from the Upper House's Committee on Audits). Article 33 of the Board of Audit's mandate states that "In case the Board of Audit deems that an official in charge of fiscal transaction of the State has committed a crime while discharging his duties, it shall notify the Public Prosecutors Office of the matter." However, Article 33 has never been

(b) Fiduciary risk and corruption

The World Bank's Country Procurement Assessment Report (CPAR) and Country Financial Accountability Assessments (CFAA) indicate that developing countries face serious problems in terms of fiduciary risk, and transparency and accountability of public financial management in general. In particular, these reports point out that the PFM capacities of local governments, which are attracting more attention as decentralization moves forward, are inferior to those of central governments.

Developing countries face serious problems with respect to fiduciary risk, and transparency and accountability of PFM.

Although lack of data makes it difficult to compare the degrees of fiduciary risk and corruption, as well as the extent of accountability in the public sector, the 2003 Corruption Perceptions Index (CPI) provides some idea (see Table 3-4). Many donors are actively involved in providing aid in the public financial sector to establish, revise, and implement legislation, reorganize and strengthen organizations, eliminate corruption and advocate ethical standards.

Lack of data makes it difficult to compare the degrees of fiduciary risk and corruption.

Table 3-4 Corruption Perceptions Index (CPI) in 2003

Order	Country[1]	CPI Score in 2003[2]	Number of Surveys[3]
Best: 1	Finland	9.7	8
21	Japan	7.0	13
70	Ghana	3.3	6
76	Senegal	3.2	6
83	Malawi	2.8	4
86	Mozambique	2.7	5
88	Madagascar	2.6	3
92	Ethiopia	2.5	5
92	Tanzania	2.5	6
92	Zambia	2.5	5
113	Uganda	2.2	6
122	Kenya	1.9	7
Worst: 133	Bangladesh	1.3	8

Note 1 : Burkina Faso and Niger are not included in this table.

Note 2 : 'CPI Score in 2003 relates perceptions of the degree of corruption as perceived by business people, academics and risk analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

Note 3 : 'Surveys used' refers to the number of surveys that assessed a country's performance. A total of 17 surveys were used from 13 independent institutions, and at least three surveys were required for a country to be included in the CPI.

Source: Transparency International (2004), "Global Corruption Report 2004," pp. 284-286.

(2) Oversight by legislature and public

In a regime of financial democracy, the voices and needs of the public are reflected in the decision-making of the executive branch through the legislature.

Citizens are taxpayers as well as the beneficiaries of public finance as consumers of the government's services and goods. In a regime of financial democracy, the voices and needs of the public are reflected in the decision-making of the executive branch through the legislature. However, in many developing countries, it is perceived that policy fails to reflect public needs, and that public oversight of government activities is not adequate due to a weak democracy and legislature's supervisory function, and too large public administrations. To address this situation, measures are adopted encouraging public participation in the policy formulation process such as the PRSP. The section below will discuss (a) oversight of budget process by legislature, and (b) oversight of budget process by public.

(a) Oversight of budget process by legislature

The legislature has the authority to approve budget and permit administration to execute budget.

The legislature has the authority to approve a budget and permit administration to execute the budget. If the legislature fails to adequately debate budget proposals, it is not exercising its authority and fails in its responsibility to be accountable to the public.

PEFA PMF
PI-27 Legislative scrutiny of the annual budget law.

PEFA indicator "PI-27 Legislative scrutiny of the annual budget law" assesses the legislature's role in debating the budget. It assesses the following dimensions:

(i) Scope of the legislature's scrutiny
(ii) Extent to which the legislature's procedures are well-established and respected
(iii) Adequacy of time for the legislature to provide a response to budget proposals for both the detailed estimates and, where applicable, for proposals on macro-fiscal aggregates earlier in the budget preparation cycle (time allowed in practice for all stages combined)
(iv) Rules for in-year amendments to the budget without ex-ante approval by the legislature

The legislature is responsible for rigorously verifying budget execution results by scrutinizing financial accounts.

The legislature is responsible for rigorously verifying budget execution results by scrutinizing financial accounts. This scrutiny is usually entrusted to audit committees, which examine financial statements and audit reports, and questions the responsible parties[30] about the audit reports. The audit committee may also recommend actions and sanctions to be implemented by the executive, in addition to adopting the recommendations made by the external auditors.

[30] For example, responsible parties are represented by the Prime Minister in Japan, and by the President in the US.

The timeliness of the legislature's scrutiny can be affected by the timing of the audit report submissions. Audit boards tend to be late in submitting their reports, in such cases the legislature may direct the committee to give first priority to auditing organizations that have a history of poor compliance.

PEFA PMF
PI-28 Legislative scrutiny of external audit reports.

PEFA indicator "PI-28 Legislative scrutiny of external audit reports" assesses the following dimensions:

(i) Timeliness of examination of audit reports by the legislature (for reports received within the last three years)
(ii) Extent of hearings on key findings undertaken by the legislature
(iii) Issuance of recommended actions by the legislature and implementation by the executive

(b) Oversight of budget process by public

In PRSP countries the governments are facilitating consultations with a wide-range of stakeholders to form long-term policies and a budgetary framework, and to assess the outcomes of policy implementation.

In PRSP countries the governments are facilitating consultations with a wide-range of stakeholders (the private sector, NGOs, etc.) to form long-term policies and a budgetary framework, and to assess the outcomes of policy implementation. In general, the public's voices are reflected in policies through legislature in countries with parliamentary democracies. However, in the PRS process, the public is expected to take an even more active role in the process of developing and monitoring the PRSP indicators, and of MTEF establishment. In many cases, the public is given the chance to oversee the budget process through direct participation in the public expenditure review.

3-5 Donor aid practices

(1) Alignment of procedures

The importance of alignment of aid procedures to PFM of recipient country is recognized.

In some cases, donor-supported projects employ different administrative methods than the recipient country's PFM, as the donors must remain accountable to their own country. This is evidence that the donor does not trust recipient countries to administer these projects. This project management not only increases transaction costs of aid, but it also prevents improvement of these countries' PFM capacities, which is essential to achieve development. Hence, the importance of alignment of aid procedures to PFM of the recipient country is now recognized.

Aligning donors' procedures to the ones of the recipient country exposes donors to risks of accountability.

However, donors are presented with a dilemma: aligning their procedures to the practices of the recipient country and providing aid through that country's PFM exposes donors to risks of accountability. It also means that PFM in developing countries is generally inadequate and its improvement is necessary to achieve development goals. Recently, donors have begun to respond to this dilemma by accepting the financial accountability risks and focusing more on PFM capacity-building as a policy decision and choosing to provide budget support. Donors with the policy that the risk cannot be acceptable will need to provide technical assistance for reduction of the risk, to disclose aid information for the alignment to improve aid processes. With this background, (a) predictability and information disclosure of donor assistance, and (b) alignment of aid procedures will be discussed in the following sections.

Recently, some donors began accepting the accountability risks and chose to provide budget support.

(a) Predictability and information disclosure of donor assistance

Aid predictability is particularly important when a donor is providing budget support.

Aid predictability is particularly important when a donor is providing budget support. Budget support is managed as part of the recipient government's cashflow just as with tax revenue since the donor deposits the funds directly into the treasury. For this reason, poor predictability of inflows of the budget support and changes in the in-year distribution of fund transfers can delay budget execution and impair the government programs.

The predictability of the amount and timing of the budget support and in-kind contributions by donors has a significant impact on the activities of the recipient government.

The predictability of the amount and timing of the budget support and in-kind contributions by donors has a significant impact on the activities of the recipient. It is desirable for the project implementing department of the government to manage donor contributions by forming a consolidated budget. However, this is not possible without prior information of the amount and content of such contributions. Inadequate information concerning the in-flow of external resources harms the government's budget comprehensiveness and its ability to effectively allocate resources.

PEFA PMF
D-1 Predictability of direct budget support.

PEFA indicator "D-1 Predictability of direct budget support" assesses the following dimensions:

(i) Annual deviation of actual budget support from the forecast provided by the donor agencies at least six weeks prior to the government submitting its budget proposals to the legislature (or equivalent approving body)

(ii) In-year timeliness of donor disbursements (compliance with aggregate quarterly estimates)

PEFA indicator "D-2 Financial information provided by donors for budgeting and reporting on project and program aid" assesses the following dimensions:

(i) Completeness and timeliness of budget estimates by donors for project support
(ii) Frequency and coverage of reporting by donors on actual donor flows for project support

Donors providing budget support pay a great deal of attention to the timing of fund transfer and treatment of information regarding the support. In countries such as Ethiopia, Tanzania, Mozambique and Uganda that receive significant amounts of budget support from donors, the government and donors have created a forum in which they can work together to reduce the uncertainties regarding the timing and amount of budget support. However, it appears that the recipient governments are not really being provided with much information on budgets and in-kind contributions for project support.

PEFA PMF
D-2 Financial information provided by donors for budgeting and reporting on project and program aid.

Countries receiving budget support have created a mechanism to reduce the uncertainties regarding external aid.

(b) Alignment of aid procedures

Until recently, great importance was placed on donors' accountability to their own governments, so that donors used their own aid procedures without much alignment with procedures of a recipient county. However, it has been recognized that without alignment such projects incur high transaction costs and do not contribute to the improvement of management systems.

Because donors follow their own aid procedures, assisted projects incur high transaction costs.

Alignment in aid procedures means that procedures of donor assistance are consistent with budget formulation, execution, and auditing processes of a recipient country. Under this definition, general budget support is most closely aligned to the recipient country's systems, while projects that are run independently of those systems have the lowest alignment.

Alignment in aid procedures means that donor assistance procedures are consistent with policy formulation and PFM procedures of a recipient country.

PEFA indicator "D-3 Proportion of aid that is managed by use of national procedures" assesses the proportion of aid funds of a particular donor channeled through budget support to overall value of aid provided by the donor.

PEFA PMF
D-3 Proportion of aid that is managed by use of national procedures.

(2) Accountability of aid

The previous section addressed the dilemma that donors face in remaining accountable to their own countries and also helping to strengthen developing countries' PFM capacities. This section addresses (a) fungibility of aid funds and (b) aid for the PFM sector, both of which are related to the issue of accountability.

Due to fungibility of money, external aid provided in any forms, such as general budget support and in-kind support, influences budget allocations of entire government.

(a) Fungibility of aid funds

Because funds are fungible, a recipient country is able to invest more resources regardless of aid money being provided in cash or in-kind. For example, in-kind contribution frees up the money that the recipient government would have used to buy goods which actually were donated. Alternatively, cash contributions reduce the budget of a division running a project, and the decreased amount can be shifted to another division. This stands out even more when the aid provided is general budget support because the support increases the total revenue of the government influencing estimated allocations of the entire government. On the other hand, in-kind assistance has limited influence on budget allocation because in-kind contributions are mostly off-budget activities.

Fungibility of aid funds is an important issue for donors providing general budget support, and they are interested in the allocation of the overall budget.

This fungibility of aid funds is an important issue for donors providing general budget support. The funds freed up by the money received from donors could be used for military expenses, or the funds increased with budget support could be distributed among a large number of programs, with none getting enough to be of real use. For this reason, donors providing budget support are interested in the allocation of the overall national budget.

(b) Aid for PFM sector

Weak PFM is one of the reasons that much of the aid provided to developing countries has not translated into significant outputs.

As described in Chapter 2, PFM is a basic tool in government management. Weak PFM is one of the major reasons that much of the aid provided to developing countries in Africa has not translated into effective economic development and social infrastructure. Against this background, the urgent need to reduce debts has triggered interest in the PFM sector among HIPC governments and donors.

In the context of HIPC initiative and PRSP, donors have increasingly paid more attention to supporting PFM in developing countries.

At the same time, donors that advocate budget support are concerned about the need to remain accountable to their own governments about the money donated. Donors cannot be accountable if the recipient government receiving budget support does not improve its financial accountability. Thus, donors need to actively provide technical support to improve PFM capacities. Japan also can play a major role in providing technical support for PFM.

Box 3-10: Interference in internal affairs and policy by donors

Is influencing policies of recipient governments through budget support and other aid schemes interference in internal affairs? It can be argued in the following ways:

One condition necessary to establish interference in internal affairs or violation of sovereignty of a state is that the state must recognize being forced by policy decision-making by external powers. In this case, the country may appeal to the International Court of Justice against such forced decision-making. Thus, when judging the presence of the interference, the relationship between the sovereign states involved needs to be considered.

In the process of development assistance, a donor country provides its resources and services to a recipient country based on agreements between them. These agreements are formed with the intention that the assistance provided through various aid modalities will contributes to the development of the recipient country. Since the 1980s, donors have assisted recipient countries' efforts to form appropriate policies through development assistance. Because this can be considered as mutually agreed policy interference, it is different from the interference in internal affairs or violation of sovereignty.

Box 3-11: Distinctive features of PFM systems in Anglophone and Francophone countries in Africa

IFM's 2003 survey compared PFM systems in Anglophone and Francophone countries in Africa and determined that the Francophone countries had a slight advantage. However, the IMF concludes that these advantages are not being realized as PFM systems, which are not functioning properly in either region.

As shown in the table below, the centralized expenditure control and internal audit system in the Francophone regions should ensure that fiscal reports and regular accounting reports are prepared quickly and efficiently. Accordingly, the Francophone countries would have an advantage over the Anglophone countries in terms of overall government budget control.

Nevertheless, as shown in the "comparison and evaluation" column, both regions face innumerable problems in running PFM systems. Thus, any distinctive strength of the individual PFM system fail to influence the performance of the system as a whole because the system is not run properly.

Comparison of PFM systems in Anglophone and Francophone countries in Africa

Area of PFM	Anglophone countries[1]	Francophone countries[2]	Comparison and evaluation
Expenditure control	Spending ministries are primarily responsible for expenditure control.	The Ministry of Finance exercises ex ante expenditure control prior to payment.	The centralized expenditure control of the French-based PFM system is preferable, but in reality the system does not appear to be functioning well in either the Francophone or the Anglophone regions.
Internal audit	Internal audit partly decentralized to spending ministries.	Centralized internal control and internal audit, which are strongly ingrained in the system.	The centralized internal audits of the French-based PFM system are preferable, but in reality the system does not appear to be functioning well in either the Francophone or the Anglophone regions.
Accounting system and fiscal reporting	Spending ministries are responsible for preparing the primary records of expenditure commitments and payments; difficult to identify accounts payable.	Accounting framework is logical: changes in treasury balances equal flows of transactions. Accounts payable at the treasury can be identified. Centralized accounting should facilitate fiscal reporting.	The Francophone regions have a better system for fiscal reporting. However, the system does not function well due to its complexity, as evidenced by the fact that some segments use accrual-based accounting. The system does not appear to be functioning well in either the Francophone or the Anglophone regions. The responsible party is not penalized when fraud is uncovered in either country, which is a key factor in the failure of these systems.
Banking arrangements	Accounts can also be opened in commercial banks.	Greater centralization of bank accounts in central bank (no payment by spending ministries).	The system in the Francophone region is clearly superior in this respect, and some countries in the Anglophone region imitate the Francophone region by centralizing bank accounts in the central bank. However, both Anglophone and Francophone countries abandon this principle for donor-financed expenditures. Further, in Francophone countries, public enterprises are often obliged to deposit any surplus funds at the treasury; to the extent that the treasury allows enterprise deposit accounts to go into overdraft, the government is lending to these enterprises in a nontransparent manner.
Fiscal discipline		To support the fixed exchange rate regime of the CFA franc, borrowing from the central bank has always been planned and limited.	Whereas the fiscal rule limiting government borrowing from the central bank has had a favorable impact on macroeconomic stability, it has resulted in cash shortages and banking crises in Francophone Africa. In contrast, some Anglophone countries have experienced bouts of high inflation due to central bank financing of unplanned fiscal deficits.
External audit and parliamentary control	Auditor General's position is independent of the executive.	External audit agency is independent of both the executive and legislative branches.	In Anglophone countries, the Auditor General's Offices have a long tradition of preparing annual reports, but both regions lack the necessary human resources. Very few African countries are able to present audited annual accounts to Parliament within 12 months after the end of fiscal year.

Notes: 1) The Anglophone countries surveyed are Gambia, Ghana, Malawi, Tanzania, Uganda and Zambia (of which four are covered in this handbook's study). 2) The Francophone countries surveyed are Benin, Burkina Faso, Cameroon, Chad, Guinea, Madagascar, Mali, Mauritania, Niger and Senegal (of which four are covered in this handbook's study).
Source: IMF Working paper: a comparison between two public expenditure management systems in Africa, 2003.

4-1 How to analyze public financial management using MTEF and budget documents?

MTEF and annual budget documents contain such a large amount of information that a comprehensive understanding seems to require a significant amount of background information regarding government processes. Well-designed budget documents present policies and their backgrounds, and justifications of planned programs and activities clearly and concisely so that even laypersons are able to understand the relationships between means of policy implementation and allocations of resources to these[31].

Well-designed budgets present their contents so that even laypersons are able to understand the relationships between policies and allocations of resources.

Case study Tanzanian MTEF

The table below presents part of 2005/06 budget formulation guidelines of the Government of Tanzania, the Tanzanian version of MTEF.

Tanzania fiscal year 2005/06 budget guidelines (MTEF) summary

Budget Items	2004/05 budget		2005/06 budget			2006/07 estimates			2007/08 estimates		
	10bill. TShs	%	10bill. TShs	%	Inc. %	10bill. TShs	%	Inc. %	10bill. TShs	%	Inc. %
1TShs=approx. 0.1yen	a	b	c	d	e=c/a-1	f	g	h=f/c-1	i	j	k=i/f-1
1. Revenue budget total	**3,348**	**100%**	**4,103**	**100%**	**23%**	**4,356**	**100%**	**6%**	**4,561**	**100%**	**5%**
1.1 Domestic revenue	**1,739**	**52%**	**1,983**	**48%**	**14%**	**2,261**	**52%**	**14%**	**2,581**	**57%**	**14%**
1.2 Grants and loans from donors	**1,367**	**41%**	**1,995**	**49%**	**46%**	**2,017**	**46%**	**1%**	**1,949**	**43%**	**-3%**
1.2.1 Program loans and grants	434	13%	822	20%	89%	834	19%	1%	847	19%	1%
1.2.2 Project loans and grants	587	18%	788	19%	34%	820	19%	4%	832	18%	1%
1.2.3 Basket loans	110	3%	73	2%	-33%	67	2%	-9%	3	0%	-96%
1.2.4 Basket grants	160	5%	199	5%	24%	197	5%	-1%	165	4%	-16%
1.2.5 HIPC grants (IDA, etc.)	75	2%	112	3%	49%	99	2%	-12%	103	2%	5%
1.3 Loans from banks	**241**	**7%**	**125**	**3%**	**-48%**	**78**	**2%**	**-38%**	**31**	**1%**	**-60%**
1.3.1 Non-bank loans											
1.3.2 Bank loans	231	7%	115	3%	-50%	78	2%	-32%	31	1%	-60%
1.3.3 Privatization fund	10	0%	10	0%	3%			-100%			
2. Expenditure budget total	**3,348**	**100%**	**4,103**	**100%**	**23%**	**4,356**	**100%**	**6%**	**4,561**	**100%**	**5%**
2.1 Recurrent expenditures	**2,256**	**67%**	**2,745**	**67%**	**22%**	**2,933**	**67%**	**7%**	**3,175**	**70%**	**8%**
2.1.1 Recurrent expenditures	1,775	53%	2,189	53%	23%	2,368	54%	8%	2,569	56%	8%
2.1.1.1 Salaries and benefits	551	16%	682	17%	24%	759	17%	11%	846	19%	11%
2.1.1.1.1 Salaries and benefits			577	14%							
2.1.1.1.2 Salaries increase			105	3%							
2.1.1.2 Other expenditures	1,193	36%	1,358	33%	14%	1,565	36%	15%	1,667	37%	7%
2.1.1.3 Designated Items	30	1%	148	4%	388%	43	1%	-71%	56	1%	29%
2.1.2 Compulsory expenditures	481	14%	556	14%	16%	565	13%	2%	606	13%	7%
2.1.2.1 Debt repayment total	318	9%	298	7%	-6%	309	7%	4%	330	7%	7%
2.1.2.1.1 Interests	168	5%	165	4%	-2%	177	4%	7%	184	4%	4%
2.1.2.1.2 Repayment of principal	149	4%	133	3%	-11%	132	3%	-1%	146	3%	11%
2.1.2.2 Other expenditures	163	5%	258	6%	58%	256	6%	-1%	276	6%	8%
2.2 Development expenditures	**1,092**	**33%**	**1,358**	**33%**	**24%**	**1,423**	**33%**	**5%**	**1,386**	**30%**	**-3%**
2.2.1 Domestic sources	234	7%	297	7%	27%	339	8%	14%	387	8%	14%
2.2.2 External (donor) sources	858	26%	1,061	26%	24%	1,084	25%	2%	999	22%	-8%

Source: Okuyama, March 2005, Report of project formulation officer: Tanzania 2005/06 budget guidelines.

[31] A good example of well-designed budgetary documents are those prepared by the government of South Africa.

"Program loans and grants" in the section of revenue corresponds to the funds provided through direct budget support from donors, whereas "Project loans and grants" corresponds to funds provided by sector-level budget support or common basket financial scheme. "Basket loans" and "Basket grants" are funds provided to specific financial arrangements and activities such as Poverty Monitoring Fund for PRSP monitoring.

"Recurrent expenditures" in the "Expenditure" section consists of personnel expenses and "Other expenses" which include maintenance costs, and utility and fuel costs. "Designated item" is a reserve fund which can be used to cover costs of unexpected events such as election, and expenditure specially approved by, for example, the office of the president.

The revenue presented in the table will be analyzed from the following poit of views which should be useful to examine government's MTEF and budget documents:

Increase/decrease in tax revenue

- Tax revenue is increasing steadily. The increase in domestic revenue in fiscal year 2005/06 is estimated 14%, and also 14% in fiscal year 2006/07. Since estimated real GDP growth is 6 to 7% per year, corresponding increase in tax revenues is anticipated. Donors pay particular attention to the performance of revenue collection. In Tanzania, revenue collection has been commissioned to the revenue authority which has shown good performance in collecting value-added and income tax.

Magnitudes of aid dependency

- Forty-nine (49) % of national revenue is dependent on assistance from donors. It implies that assuming constant growth of tax revenue at 5% every year, and constant total expenditure and amount of debt services, donors need to supplement the government budget at least 10 more years.
- Loans and grants from donors are increasing. Except for "Basket loan," they increased 24 to 89% from the amounts in 2004/05. This may be the result of increases in donor aid, and from disclosure of intended amounts of assistance by donors. However, in 2006/07 estimates, donor contribution shows only 1% increase maybe due to the fact that many donors could not commit the amounts of assistance two years in advance.

Borrowings from the private sector

- Borrowings from the private sector decreased. One reasons for the decline in the borrowing at high interest rate should be the better predictability of aid inflows due to disclosure of aid information. As a result, the government needs less borrowing from the private sector in order to conduct its cashflow management.
- "Program loan" and Program grant" are increasing. They are considered direct budget support.

In Tanzania assistance in the form of direct budget support is expected to increase. The expenditure will be analyzed from the following points of view:

Comparison between recurrent and development expenditures

- Increase in development budget is slow. For three years, recurrent expenditures occupy two thirds of the total expenditure, and development expenditures takes one third of the total, and ratios among subcategories are also relatively constant. This indicates that more efforts should be made to increase the portion of development budget which significantly contributes to the development of Tanzania.

Recurrent expenditures such as salaries and benefits

- In fiscal year 2005/06, the estimated "Compulsory expenditure" increased by 16%. Increase in such compulsory expenses makes public finance more rigid. However, this increase is lower than the increase in total expenditure of 23%. In addition, it is necessary to confirm the causes of the large increase (58%) in "Other expenditure" of "Compulsory expenditure."
- Personnel-related expenditures (salaries and benefits) have increased. Donors, particularly IMF, are keen to observe an increase in personnel expenditures. As shown in the table, a special increase of salaries is proposed by the government in line with the medium-term salary reform strategy formed under the civil service reform policy.
- As shown in the table below, a large portion of recurrent expenditures is covered by donor contributions. More than a third of the recurrent budget in fiscal year 2005/06 is expected to be financed by donors. This part of recurrent expenditures are to be financed partly from funds provided through budget support indicated in "Program loan and grant," and "Project loan and grant" revenue items.

Tanzania fiscal year 2005/06 budget guidelines (MTEF) summary
Sources of recurrent and development expenditures

Budget Item	2004/05 budget		2005/06 proposed			2006/07 estimated			2007/08 estimated		
	10bill. TShs	%	10bill. TShs	%	Inc. rate in %	10bill. TShs	%	Inc. rate in %	10bill. TShs	%	Inc. rate in %
1TShs=approx. ¥0.1	a	b	c	d	e=c/a-1	f	g	h=f/c-1	i	j	k=i/f-1
2. Expenditure budget total	**3,348**	**100%**	**4,103**	**100%**	**23%**	**4,356**	**100%**	**6%**	**4,561**	**100%**	**5%**
2.1 Recurrent expenditures	**2,256**	**67%**	**2,745**	**67%**	**22%**	**2,933**	**67%**	**7%**	**3,175**	**70%**	**8%**
2.1.1 Domestic sources (tax, etc.)	1,506	45%	1,686	41%	12%	1,922	44%	14%	2,193	48%	14%
2.1.2 External (donor) sources	509	15%	934	23%	83%	933	21%	0%	950	21%	2%
2.1.3 Bank loans and other sources	241	7%	125	3%	-48%	78	2%	-38%	31	1%	-60%
2.2 Development expenses	**1,092**	**33%**	**1,358**	**33%**	**24%**	**1,423**	**33%**	**5%**	**1,386**	**30%**	**-3%**
2.2.1 Domestic sources (tax, etc.)	234	7%	297	7%	27%	339	8%	14%	387	8%	14%
2.2.2 External (donor) sources	858	26%	1,061	26%	24%	1,084	25%	2%	999	22%	-8%

Source: Okuyama, March 2005, Report of project formulation officer: Tanzania 2005/06 budget guidelines.

Case study National budget of Tanzania

PEFA's PFM Performance Measurement Framework (see Table 3-2 on page 27) includes a number of indicators related to budget. Using these indicators, examples of simple assessment of the Tanzanian budget will be introduced below.

Budget documents of the Government of Tanzania are disclosed on its website (www.parliament.go.tz/). According to PFM indicator "PI-10 Public access to key fiscal information," this is a desirable arrangement. Of course, only a limited number of people in Tanzania are able to access these documents through the internet, hardcopies of the budget need to be widely available.

Next two pages a part of the recurrent and development of 2005/06 budget of Ministry of Agriculture and Food Security is presented. In order to assess reliability of the budget, PFM indicators "PI-1 Aggregate expenditure out-turn compared to original approved budget" and "PI-2 Composition of expenditure out-turn compared to original approved budget" need to be considered. According to these indicators, information presented in the budget is not comprehensive since audited expenditures in fiscal year 2003/04 corresponding to budgeted amounts are not included in the budget. In order to complete this assessment the audited expenditures need to be known. However, including the audited expenditures in the budget documents is considered good practice.

"PI-3 Aggregate revenue out-turn compared to original approved budget"

On the website information regarding the report of settlement accounts for fiscal year 2003/04 and the year before (2002/03) is missing. There needs to be improvement with respect to disclosure of PFM information.

"PI-5 Classification of the budget"

In terms of presentation, recurrent budget and development budget are presented in different formats. The smallest unit of budget presentation is "Sub-vote" corresponding to programs under ministries in which both recurrent and development budgets are shown separately. In order to examine possible gains in efficiency and effectiveness of programs, supporting documents for this budget with more detailed estimations is required for analysis and examination. For example, in the development budget, an aggregated estimate is shown in each project. However, detailed supporting documents with estimations for each project needs to be examined in order to consider improvements in implementation procedures regarding a particular project.

"PI-6 Comprehensiveness of information included in budget documentation"

It is good practice to include donor contributions in the development budget. Whether all donor contributions are captured in this budget cannot be ascertained. However, it can be assumed that most of these contributions are captured as donor coordination is in the advanced stage in Tanzania.

"PI-8 Transparency of inter-governmental fiscal relations"

Transparency of the budget seems to be high because unconditional and conditional grants to provincial government, district councils and their executive bodies are clearly presented. However, to achieve operational-level transparency information in the budget documents is not sufficient. Additional reports of settlement of accounts, and other evidences of proper budget execution are necessary to verify operational-level transparency.

Tanzania 2005/06 recurrent budget: Ministry of Agriculture and Food Security

Vote 43 Ministry of Agriculture and Food Security

A. ESTIMATE of the amount required in the year ending 30th June, 2006, the salaries and expenses of **Ministry of Agriculture and Food Security**

Fifty-four billion six hundred thirty-four million eight hundred twenty-three thousand nine hundred

(Shs. 54,634,823,900)

B. Sub-Votes under which this vote will be accounted for by the **Permanent Secretary, Ministry of Agriculture and Food Security**, are set out in the details below.

Item	Description	2003/2004 Actual Expenditure Shs.	2004/2005 Approved Estimates Shs.	2005/2006 Estimates Shs.
PROGRAMME 10 ADMINISTRATION				
Subvote 1001	**ADMINISTRATION AND GENERAL**			
250100	Basic Salaries-Pensionable Posts	250,788,600	269,470,786	285,034,700
250200	Basic Salaries-Non-Pensionable Posts	0	0	2,500,000
250300	Employment Allowances	179,621,570	233,479,500	524,726,000
260100	Communication, Information, Supplies and Services	68,644,704	84,800,000	94,780,000
310400	Acquisition of Technical Equipment and Tools	10,057,227	13,000,000	21,200,000
310500	Mobile Vehicles and Self-Propelled Equipments	136,000,000	0	85,000,000
310600	Plant Equipment and Machinery	0	1,500,000	2,000,000
310800	Rehabilitation, Renovation and Replacement of Equipment	0	24,000,000	40,000,000
310900	Construction of Other Civil Works	590,787	0	100,000,000
Total of Subvote		**1,345,570,083**	**1,219,470,786**	**2,215,634,700**
PROGRAMME 20 CROP DEVELOPMENT				
Subvote 2001	**CROP DEVELOPMENT**			
250100	Basic Salaries-Pensionable Posts	1,190,732,000	1,476,266,006	1,539,666,000
250200	Basic Salaries-Non-Pensionable Posts	81,138,000	64,300,000	80,322,400
250300	Employment Allowances	660,143,179	421,434,300	903,020,000
260100	Communication, Information, Supplies and Services	76,228,169	116,113,200	167,725,000
260200	Educational Materials, Supplies and Services	14,210,000	17,200,000	41,518,000
260300	Hospitality	16,458,279	12,718,300	15,735,000
310900	**Construction of Other Civil Works**	10,000,000	0	165,000,000
330100	**Land and Development Rights to Land**	0	12,000,000	20,000,000
330300	**Intangible Assets**	1,000,000	0	0
Total of Subvote		**9,838,920,885**	**16,988,718,402**	**22,591,824,000**

Note: Because the expenditure items in this subvote are arbitrarily selected from the original budget document, the totals presented here are not equal to the totals of the items presented in this table.

Tanzania 2005/06 development budget: Ministry of Agriculture and Food Security

Vote 43 Ministry of Agriculture and Food Security

A. ESTIMATE of the amount required in the year ending 30th June, 2006, for the development projects in the Ministry of Agriculture and Food Security

Sixty-three billion four hundred ninety million

(Shs.63,490,000,000)

B. Projects under which this Vote will be accounted for by the Permanent Secretary, Ministry of Agriculture and Food Security, are set out in the details below.

Item	Description	2003/2004 Actual Expenditure Local	Forex	2004/2005 Approved Estimates Local	Forex	2005/2006 Estimates Local	Forex	Loan/ Grant	C/R/D	Donor	Total
		Shs		Shs		Shs					Shs
Sub Vote 1001	**ADMINISTRATION AND GENERAL**										
5492	Tanzania Multi-Sectoral AIDS Project	0	0	0	0	0	100,000,000	G	D	World Bank	100,000,000
Total of Subvote		**0**	**0**	**0**	**0**	**0**	**100,000,000**				**100,000,000**
Sub Vote 2001	**CROP DEVELOPMENT**										
4426	National Agriculture Extension ProjectII	400,000,000	1,900,000,000	400,000,000	0	0	0				0
4458	Stabex Coffee	0	3,262,055,500	0	0	0	0	G	D	EU	0
4466	Special Programme for Food Security	0	492,698,000	0	0	100,000,000	60,386,900	L	D	FAO	160,386,900
4484	Support to Agri. Extension Service Refor	0	1,634,000,000	0	0	0	0	G	D	France	0
6465	River Basin Mgt and Small Irr.Impro.Proj	0	1,140,200,000	0	0	0	0	L	D	World Bank	0
6466	Participatory Agriculture Devt Programme	1,004,357,000	6,220,336,995	448,000,000	9,544,765,592	454,000,000	9,541,765,600	L	D	World Bank	9,995,765,600
Total of Subvote		**1,553,757,000**	**14,864,944,472**	**948,000,000**	**9,665,133,592**	**654,000,000**	**9,602,152,500**				**10,256,152,500**

Note: Because the expenditure items in this subvote are arbitrarily selected from the original budget document, the totals presented here are not equal to the totals of the items presented in this table.

4-2 How to understand and handle PFM assistance in developing countries?

4-2-1 Acquisition of knowledge

(1) How should PFM conditions in target countries be studied?

Since PFM is an interdisciplinary field, the type of PFM knowledge required is dependent on the ways PFM experts and members of aid agencies need to use it in their field of assistance. Those providing technical services related to PFM would be interested in improvement of PFM capacities of recipient countries, whereas those who manage direct budget support processes might be interested in fiduciary risks and outcomes of such budget support.

Type of PFM knowledge required is dependent on the ways PFM experts and members of aid agencies need to use in their field of assistance.

In order to acquire a good understanding of PFM in a country of interest, budget documentations and budget speeches of finance ministers should be reviewed. However, due to time constraints and other possible reasons only a few people will turn to budget documents. An easier approach is to refer to reports assessing PFM conditions in that country. For example, World Bank's Public Expenditure Review (PER), Country Financial Accountability Assessment (CFAA), and Country Procurement Assessment Report (CPAR) can all be easily obtained (on the World Bank's website). A brief overview of these reports is as follows:

To acquire a good understanding of PFM, budget documentations and budget speeches of finance minister should be reviewed.

An easier approach is to refer to reports assessing PFM conditions.

PER:	Analysis focuses on budget allocation and its expenditures; also analyzes the links between policies and budget formulation as well as monitoring.
CFAA:	Primarily covers process from budget execution to audit; the World Bank Board of Executive Directors examines the relevant country's CFAA when deciding whether to offer Poverty Reduction Support credit (PRSC).
CPRA:	Assesses the reliability of the relevant country's procurement pro-

IMF reports and data are useful for those interested in learning about a country's macroeconomic conditions. These can also be downloaded from the IMF website (http://www.imf.org/external/country/index.htm).

IMF reports and data are useful to learn about macroeconomic conditions of a country.

The public Expenditure and Financial Accountability (PEFA) project in 2001 began to address the need for (1) tools to comprehensively assess a country's budget process, and (2) tools that can be used by all donors including the World Bank. To date, pilot assessment programs have been conducted in 10 to 20 countries. As PEFA's assessment methodology spreads, PEFA reports will also

As PEFA's methods gain popularity, PEFA reports will also be a good reference.

become a good reference. Refer to Chapter 3 for an explanation of PEFA indicators and its recent trends.

IMF's Government Finance Statistics Manual 2001 outlines standards used in compiling fiscal statistics, and is an authoritative document used for budget design.

IMF's Government Finance Statistics Manual 2001 outlines the international standards to be used in compiling and presenting fiscal statistics in both developed and developing countries. This rather technical authoritative document is well-known for budget design. It defines the system for expense categories to be used in budgets. The manual also includes a glossary. In addition, IFM's "Manual of Fiscal Transparency (Code of Good Practices on Fiscal Transparency)" and "Guidelines for Public Expenditure Management" are useful references. All of these documents can be downloaded from the IMF website.

Asian Development Bank's "Managing Government Expenditure 1999" can be used as a PFM reference book.

Asian Development Bank's "Managing Government Expenditure 1999" can also be used as a reference book of PFM for developing countries. It gives an overview of PFM with particular emphasis on public expenditures. This document is used as the World Bank's primer in PFM training.

World Bank's "Public Expenditure Management Handbook 1998" was prepared for staff in charge of PFM projects in developing countries.

World Bank's "Public Expenditure Management Handbook 1998" was prepared for staff in charge of PFM projects in developing countries, and includes a diagnostic questionnaire that can be used as is on location. Much of the report is related to PEFA indicators, and it also includes many examples from developing countries in text boxes throughout the report. The handbook can be downloaded from the World Bank website[32].

There are other materials as well, analyses of countries that have introduced programs to improve governance and PFM (public sector reforms, etc.), which can provide an understanding of PFM in those countries.

It is probably easier to understand PFM in developing countries by beginning with a study of Japanese systems, which would be more familiar to Japanese readers.

It is probably easier to understand PFM in developing countries having studied the Japanese PFM systems, which are more familiar for the Japanese audience. One example of the many reference books about Japan's fiscal management is Kawakita's (ed.) "Heisei 16 nendo zusetu nihon no zaisei" [Fiscal 2004 Japan's finances in diagrams] which is particularly helpful as it is based on an actual budget.

There are projects with developing countries and donors working together to prepare CFAA and CPAR. JICA experts and country office staff could join in these projects of PFM analyses representing the intellectual contribution of Japan.

32 http://www1.worldbank.org/publicsector/pe/handbook/pem98.pdf

Case study Survey on fiduciary risk in Tanzania

DFID carried out a fiduciary risk assessment of Tanzania's PFM in 2004 (Comprehensive Fiduciary Risk Assessment). Japan commented on the results of the assessment, and the final report is shared by the government and donors. Studying and assessing recipient country's PFM under donor-coordination frameworks has been conducted in other countries too. Such assessments considered the following criteria:

- Does the budget serve as a fiduciary contract by which citizens receive necessary services from the government in return for their tax payments?
- Is the legislature actively involved in drafting policies and setting budget priorities within the context of the Medium-term Expenditure Framework (MTEF)?
- Are there clear rules regarding budget processes?
- Is the budget comprehensive?
- Does the budget take the poor into account?
- Does the budget serve as a guideline for policy implementation?
- Is in-year budget execution regulated?
- Is government procurement cost-effective and transparent?
- Are expenditure reports accurate and timely?
- Are government expenditures audited efficiently by an independent body?
- Are corruption and abuse of public authority penalized efficiently and systematically?
- Does the legislature effectively monitor fiscal discipline and budget execution?

(Source: Takushi Okuyama, "Study Group Members' 1st and 2nd Quarterly Reports," JICA Tanzania office, September 2004)

Box 4-1: JICA's research on PRSP and PFM

JICA has conducted the research outlined below, which should be helpful when studying PFM in a specific country.

-"Research on Poverty Reduction Strategies, Basic Research on Poverty Reduction," April 2001.

Issues covered: Global trends in poverty reduction; definition of PRSP; JICA's cooperation with PRSP; case studies in Cambodia, Nicaragua, Bolivia, Kenya, Tanzania.

Note: The report does not refer directly to PFM.

http://www.jica.go.jp/activities/report/field/2001_01.html

-"Financial Management and Aid in Developing Countries, Report: New Trends in Aid and Reforms in Developing Countries," February 2003.

Issues covered: Theoretical and historical background of fiscal management; definition of fiscal management; fiscal management in developing countries (case study of Tanzania); JICA's role

http://www.jica.go.jp/activities/report/field/2003_04.html

-"Disquisition on PRSP and Aid Cooperation"

Issues covered: PRSP's effectiveness; approaches to poverty reduction and Japan's role; trends in aid approaches and strategies; sector programs and Japan's response; trends in Tanzania and Japan's cooperation

Note: The paper provides a review of public expenditure in Tanzania and introduces aid trends.

http://www.jica.go.jp/activities/report/field/200403_01.html

-"Case Studies of the PRSP Process: Learning from Experiences in Tanzania, Ghana, Vietnam and Cambodia"

Issues covered: Definition of PRSP; examples of PRSP process in different countries; problems with PRSP approach and Japan's response; establishing PRSP with participatory approach in Bolivia

Note: The paper introduces trends in PFM reforms in Tanzania, Ghana, Vietnam and Cambodia.

http://www.jica.go.jp/activities/report/field/200412_01.html

(2) What are the strategies of other donors?

It would be useful to prepare ahead of attending donor meetings by studying donor guidelines and other materials, in addition to the handbooks discussed above. All reports can be downloaded from the respective websites. This section will provide examples of strategies from the World Bank, IMF and DFID.

It would be useful to prepare ahead of attending donor meetings by studying donor guidelines.

The World Bank

The World Bank became involved with PFM in developing countries in the early 1980s. In the early stages, its aid was limited to public investment reviews (PIRs), which focused solely on how the effectiveness of public investments could be improved with a better use of money[33]. Subsequently, the World Bank widened its scope to include budget allocation, and then PFM overall.

The World Bank became involved with PFM in developing countries in the early 1980s.

"Reforming Public Institutions and Strengthening Governance: A World Bank Strategy," published in 2000, outlines the Bank's strategy for PFM. As is clear from the title, the strategy involves improving overall governance in the public sector without focusing exclusively on PFM. The report states that the areas that need to be addressed the most to improve governance are public expenditures and fiscal operations, and revenue (taxes and customs) policies. On the other hand, the World Bank addresses governance issues within the PRSP framework in countries that have introduced PRSP. Its three-level structure consisting of PRSP, governance and PFM allows the World Bank to address governance within the PRSP framework, and PFM within the governance framework.

"Reforming Public Institutions and Strengthening Governance: A World Bank Strategy," published in 2000, outlines the Bank's strategy for PFM.

The World Bank provides loans to finance programs to strengthen governance in the form of Poverty Reduction Support Credit (PRSC), part of which consists of a grant. It also provides technical support, such as public expenditure diagnosis, analysis of PFM policies and aid to strengthen organizations, and enhance the efficiency of procedures. In addition, it provides technical support to introduce information systems. Recently, it has provided aid to introduce MTEF, based on New Public Management theories.

The World Bank also provides technical assistance.

The World Bank Institute[34] (WBI) offers training courses in PFM to employees of developing country governments and NGOs, as well as to World Bank staff. It also provides training for World Bank staff members only, such as (1) public expenditure analysis and management, and (2) budget

The World Bank provides training in the PFM field.

[33] World Bank 2001, Public Expenditure Management and Accountability: Evolution and Current Status of World Bank Work.

[34] World Bank Institute plans and implements training programs targeting experts and managers from developing country governments, research institutes, companies, the media and NGOs.

execution, each typically lasting two to three days. The training material is available on the website[35].

International Monetary Fund (IMF)

IMF was founded to provide PFM financial and technical support to member countries.

IMF was founded to provide PFM financial and technical support to member countries. The IMF's work can be categorized into three main types: (1) surveillance, involving the monitoring of economic and financial developments, and the provision of policy advice, aimed especially at crisis-prevention; (2) lending to countries with balance of payments difficulties, to provide temporary financing and to support policies aimed at correcting the underlying problems; and (3) technical assistance and training in its areas of expertise. PFM is included in its targets coming under surveillance[36]. IMF regularly sends missions to countries, provides Article IV Consultation[37] and monitors that country's financial condition[38].

IMF primarily provides assistance with balance of payments, and is not very involved with technical assistance.

While the World Bank focuses on structural and organizational reform in the PFM field, and improving the efficiency of resident services, IMF works to stabilize macroeconomic conditions and maintain fiscal balance. The World Bank provides medium- to long-term loan adjustment, investment and loans, grants, advice and technical assistance[39], IMF primarily provides assistance with balance of payments and is not very involved with technical assistance. IMF's technical assistance is usually provided as part of its financial assistance programs, rather than as an independent program. The majority of its technical assistance in the Sub-Saharan region is the dispatch of experts. These experts' work is primarily focused on budget execution, accounting and treasury management, there is little involvement with regional decentralization of financial management or debt management. According to an IMF report, it has no plans to increase its budget for technical assistance[40].

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35 http://web.worldbank.org/WBSITE/EXTERNAL/WBI/0,,contentMDK:20111566~menuPK:556287~pagePK:209023~piPK:207535~theSitePK:213799,00.html#p

36 http://www.imf.org/external/np/exr/facts/jpn/glancej.htm

37 This consultation is called "Article IV Consultation." Articles of Agreement of the International Monetary Fund grants IFM authority to inspect member states' monetary systems. The member states are obliged to cooperate with IMF and provide necessary information.

38 IMF not only monitors debt, but also reviews economic growth, finances, balance of payments and statistics, and may also address a sector topic.

39 The World Bank, 2002, Reforming Public Institutions and Strengthening Governance: A World Bank Strategy.

40 IMF, 2004,Technical Assistance Evaluation Program -- Findings of Evaluations and Updated Program.

IMF prepared "Guidelines for Public Expenditure Management" in 1999 to introduce analytical methods for evaluation of PFM[41]. It also released "Report on the Observance of Standards and Codes," which outlines the results of an IMF review of developing countries in accordance with the "Code of Good Practices on Fiscal Transparency" mentioned in section 4-2.

IMF prepared "Guidelines for Public Expenditure Management" in 1999 to introduce analytical methods for evaluation of PFM.

Department for International Development (DFID)

DFID's "Understanding and Reforming Public Expenditure Management" in 2001 is a guideline for the PFM sector[42]. These guidelines stress the importance of PFM in poverty reduction and improving the effectiveness of aid. The report states that improving PFM enables the government to provide more effective services for its citizens, and also reduces fiduciary risk in developing countries to enhance effects of aid.

DFID argues the importance of PFM in poverty reduction and improving the effectiveness of aid.

The guidelines also assert that, as aid modalities shift from projects to sector-wide approaches (SWAPs) and to general budget support, PFM in sectors and the country overall will become even more important. DFID emphasizes that PFM reforms (at the sector level) should be one of the components when adopting SWAps.

DFID emphasizes that PFM reforms at the sector level should be one of the components when adopting SWAps.

These guidelines include a matrix to be used when analyzing PFM in a developing country. Using such analytical tools leads to a better understanding of conditions in that country and enables comparisons between developing countries.

DFID proposes a matrix to be used when analyzing PFM in a developing country.

[41] http://www.imf.org/external/pubs/ft/expend/index.htm
[42] http://www.dfid.gov.uk/pubs/files/pfma-pem.pdf

4-2-2 Project formation and PFM

(1) How should I reply when asked what Japan can do to help in the PFM field? What kind of PFM assistance is usually given?

JICA's assistance for PFM thus far consists of research and dispatch of project formulation advisors.

Recently JICA began to conduct development studies and a technical cooperation project in the field of PFM.

JICA's assistance for PFM thus far can be divided into research (see Box 4-1) and dispatch of project formulation advisors. However, in 2005, JICA has planned a development study in Tanzania and a technical cooperation project to support treasury operations in Indonesia. JBIC has experience in conducting studies in Ghana and Malawi (Special Assistance for Project Sustainability, or SAPS[43]). These studies focused on aid and debt management in Ghana, and revenue and expenditure controls in Malawi. The section below outlines the assitance that Japan could potentially provide, based on these achievements.

Participation in meetings between governments and donors

Attending government-donor meetings is an effective way of understanding the government's intentions and other donors' projects to formulate projects.

It is worthwhile to attend these conferences regularly as PFM issues are discussed. A questionnaire was given to JICA offices when the "Workshop on Cooperation with Japanese Aid Organizations in the Region" was held in Kenya in February 2005 to determine how often staff from JICA offices participate in government-donor meetings on PFM. Staff of three JICA country offices officially participate in government-donor meeting, one attends regularly, two attend occasionally, three had attended at some point in the past, and one had never attended. Anyone trying to formulate a PFM project in a country with considerable aid cooperation will find that attending these government-donor meeting is an effective way of understanding the government's intentions and other donors' projects.

Posting project formulation advisors

Project formulation advisors specialized in PFM were send to various countries.

Project formulation advisors specialized in PFM were send to Kenya and Uganda in 2005. In addition, a regional project formulation advisor was dispatched to Kenya's East Africa Regional Support Office in 2005[44].

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43 In the event that remedial action is needed or the project is not realizing the expected effect, a SAPS study would be implemented after a project is completed to determine needs and urgency of assistance. The purpose of SAPS is to investigate and identify problems that impede sustainability of a project, and to propose solutions to these problems (from the JBIC website).

44 Project formulation advisors at JICA Regional Support Office are responsible to provide technical assistance to JICA country offices, and to develop Japan's assistance strategies in the fields of PFM and aid harmonization. They are also responsible to plan and implement aid harmonization training programs, and for networking among development professionals.

Technical assistance

According to experts with experience in PFM studies[45], many donors provide assistance for PFM, but very few actually understand the conditions regarding day-to-day-level public services. Such assistance heavily relies on the so-called "three-piece set" consisting of training, information technology (IT), and manual development. A study supported by JBIC on Ghana's aid and debt management examined the demand and supply of PFM information, in order to clarify quantities, qualities, and frequency of information transactions, and institutions involved in such transactions. Results of the examinations contributed to improve efficiency of aid and debt information management processes. Workshops were held and problems were analyzed using a participatory approach which received high praise from both Ghana's government and IMF.

JICA and JBIC are conducting PFM projects and development surveys.

Development studies and technical cooperation projects

In Indonesia, a technical cooperation project was formulated to strengthen the operational capacity of Ministry of Finance's Treasury employees. In a similar fashion, a development study in Tanzania aims to train personnel and improve operations of the treasury. This study has been implemented under the framework of "Treasury management and accounting" which is part of the government's PFM reform program. The study was planned carefully to avoid duplications with other programs supported by other institutions.

In Indonesia and Tanzania, technical assistance is provided to the Treasury.

There are examples in which attempts to introduce IT to developing countries have not been smooth. For example, although an expensive information system was introduced in Ghana, it could not be used to its full potential, and the government was unable to pay the maintenance costs (refer to the case study below).

[45] Mr. Sugimoto of Shinko Overseas Management Consulting, Inc., and Mr. Ozaki of Minerva.

Case study Ghana's comprehensive PFM reform program

Ghana introduced a comprehensive PFM reform program in 2002 (running through 2007). Short-term, medium-term and long-term action plans have been prepared covering the areas of financial management reports (budget and accounting), fund management and cash management, good governance (transparency of fiscal management, strengthening revenue capacity, decentralization of public finances, fiscal legislation and regulatory reform). Donors established the Public Financial Management Donor Roundtable (primary members are CIDA, DANIDA, DFID, EU, IMF, KfW, USAID, GTZ, Embassy of Japan, JICA), and this informal meeting is used for negotiations between donors and dialogues with the government. IMF has sent experts to the Ministry of Finance.

This PFM program introduced the Budget Preparation Expenditure Management System, a large-scale financial data management system that comprehensively manages accounting, budget execution and monitoring in the public sector. An IT firm built the system and trained staff in its use. Issues remaining to be addressed include:

- Along with the introduction of hardware, capacities of institutions, organizations, and human resources necessary to manage the system need to be enhanced
- Government's ownership of the system needs to be strengthened

These issues are very common when introducing information systems. World Bank Institute held a seminar on introducing information systems in the public sector in November 2003. Outputs of this seminar can be accessed on its website[46]. Seminar's proceedings reported that the Financial Management Information System (FMIS) has been adopted in Uganda, Zambia, Burkina Faso and Malawi, in addition to Ghana, and the lessons learned from these attempts have been consolidated and summarized at the seminar.

[46] http://info.worldbank.org/etools/vod/PresentationView.asp?PID=1014&EID=502

(2) How to integrate PRSP and PFM issues when providing sector-wide assistance?

There are two objectives when a JICA's sector development officer is involved in PFM of a recipient government: 1) to improve quality of JICA's development assistance, and 2) to assist and monitor recipient government's PFM sector capacity.

There are two objectives when JICA is involved in sector PFM of a recipient government.

Two activities are suggested to achieve the first objective: improvement of quality of JICA's development assistance.

The first objective is to improve quality of JICA's development assistance.

One activity is to analyze the budget for the purpose of project development. Through conducting policy and technical dialogue with sector ministries based on the issues identified by annual sector reviews (or sector public expenditure reviews), projects and programs with high priority and urgency can be developed. Because long- and medium-term policies and development plans tend to be set without financial backing plans, it is better to examine the annual budget process to obtain information on reliable and feasible allocations of resources in support of the planned projects. Further, by examining development and recurrent budgets, and component-by-component budget allocations using information on ceilings set by a finance ministry and from budget documents, financial impacts of a newly planned project can be assessed. Such financial impacts include 1) change in budgetary allocations within a sector, and 2) additional recurrent costs borne by the government once external support ends.

The first activity to achieve the first obejctive is to analyze the budget.

The second activity is to collect PFM information for the effective implementation of projects. Through participation in the budget process, JICA is able to negotiate with a recipient government to secure the local portion of project financing. Ministry-level budget estimate usually begins six (6) to eight (8) months before the start of a new fiscal year, and this is a good time when outlines of counterpart budget required for the project implementation should be negotiated. Proposed allocations of the budget to the project can be identified in draft budget documents, but it may be too late to suggest changes of the allocation. Thus, early initiation of budget negotiations is recommended. Sometimes particular projects are quoted in a minister's budget speech indicating these projects are well-recognized by the recipient ministry.

The second activity is to collect PFM information for the effective implementation of projects.

Several examples of activities related to the second objective, which is to assist and monitor recipient government's sector PFM capacity, are country and sector specific. They are introduced below:

- As a result of various reviews including Public Expenditure Review various recommendations are made. JICA can support follow-up activities carried out

Examples of activities related to the second objective, which is to assist and monitor recipient government's sector PFM capacity, are country and sector specific.

by governments, and if these are not followed, alternative options can be suggested. Reasons for governments' weak follow-up activities include poor information sharing among government's evaluation and budget forming sections, not well synchronized timing of evaluation and budget cycle, and disconnection between evaluation process and budget negotiation and formulation process.

- JICA is able to check whether a recipient government follows procedures according to laws and regulations. Although most sector activities are implemented mainly by recipient governments, there is a special fund established for working groups in which both government and donors participate. In this case, JICA is able to contribute its capacity to examine whether the procurement of, for example, consulting services is done properly according to the laws and regulations. This in turn, contributes to the improvement of governance of relevant sector departments.

These JICA activities are likely to touch sensitive issues of the recipient government and sector departments. Thus, JICA needs to share PFM issues with other donors, and help donors consolidate their position in order to negotiate with the recipient government for improvement of PFM capacity.

JICA should contribute its experiences and understandings to the annual review and budget processes.

In addition to the above sector-level discussions concerning sector operations and resource allocation, JICA should contribute its experience and understanding obtained from its aid operations to the annual review and budget processes. JICA is thus able to support the improvement of project implementation and capacity building of recipient governments.

(3) What are the important factors to understand in PFM in the context of decentralization?

To understand PFM in local governments it is necessary to learn how funds flow from central government to local governments.

In recent years, many developing countries have implemented decentralization reforms aiming to improve the efficiency of public service delivery to meet the needs of the poor in particular. However, local governments' financial base is very weak, and central governments redistribute tax revenues to local governments in the form of unconditional grants. These grants are also means of central control over local governments. To understand PFM in local governments, it is necessary to learn how funds flow from central government to local governments. There are two major routes through which funds are released: 1) from finance ministry to a ministry of local government which distributes funds to local governments. In this case the ministry of local government handles all the funds provided to the local governments; 2) funds allocated to sector ministries are eventually released to local governments. In this case, the line ministries provide funds to their line local offices which are located at local governments, and are also responsible to the local governments (see Figure 4-1).

There is a third flow of funds and resources involving donor assistance. If donors provide funds and in-kind assistance to the line ministry and local governments directly, it is difficult capture this flow of funds, unless the donors inform the ministry of finance of the amounts of external support. Therefore, a reporting system for this type of flow of funds needs to be established, and donors need to disclose their aid information to the finance ministry.

Reporting system for flows of donor funds needs to be established, and donors should disclose their aid information to the finance ministry.

Many countries implementing decentralization policy, adopted conditional and unconditional grant financial schemes which adjust for geographical disparities between local governments. In order to control and avoid political interference, amounts of these grants are determined by a formula with characteristics variables such as poverty indicators, population, and so forth. To secure proper execution of budgets allocated to local governments, monitoring of PFM processes must be conducted.

Countries implementing decentralization, adopted grant schemes which adjust for geographical disparities between local governments.

(4) How to provide assistance in the field of PFM in the context of decentralization

As described above a central government needs to exercise tighter financial control over funds allocated to local government as decentralization policy is implemented in developing countries. Consequently, two areas of assistance can be considered by donors: (a) assistance to the fund allocation mechanism from the central government to local governments, and (b) assistance to improve PFM and budget

Two areas of assistance can be considered by donors in support of PFM under the decentralization policy.

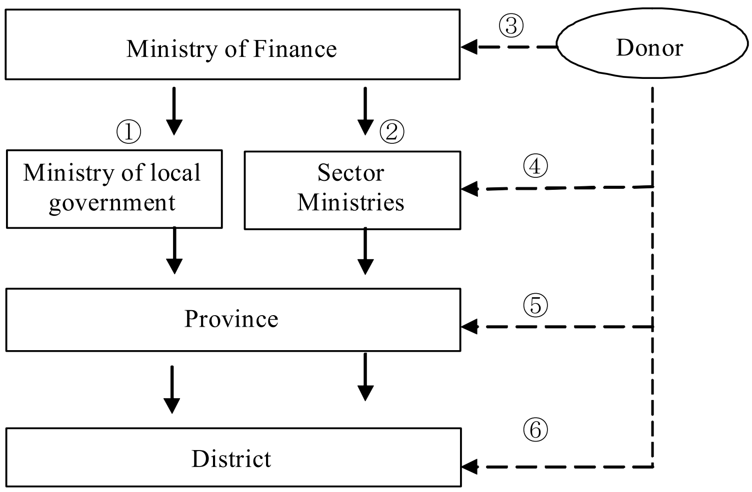

Figure 4-1 Flows of funds to local governments

execution capacities of local governments.

(a) Assistance to the fund allocation mechanism from the central government to local governments

As the devolution of revenue sources to local governments took place, integration of central and local PFM and accounting systems are underway in many developing countries.

As the devolution of revenue sources and financial resources from the central to local governments took place, many developing countries tried to integrate central and local PFM systems by introducing IFMIS. Donors have been supporting implementation of IFMIS and PFM capacity development. However, strengthening central government's supervision function through introduction of IFMIS is sometimes perceived as inconsistent with the principles of devolution of power, and even with traditional political systems. Thus, when donors provide assistance to IFMIS implementation, they need to consider not only technical aspects of IFMIS, but also the aspects of political and policy dialogue of the central and local governments.

(b) Assistance to improve PFM and budget execution capacities of local governments

Most externally supported programs concerning local governments have focused on capacity building.

Functions of PFM particular to local governments are their ability to address the needs of local people, planning, budgeting, and implementation of local activities, monitoring, reporting both to local people and the central government, and coordination among these functions. In terms of external assistance, most programs concerning local government have focused on their capacity building. It is expected, for example, at deconcentrated branches of line ministries at district level that abilities to coordinate among sector officials, and to keep consistency between plans and budget be strengthened with assistance from donors. Donors expect autonomous governments at city, town, and village level, to improve abilities of accounting, planning, service delivery, external audit to secure accountability to local people with external assistance.

4-2-3 Aid coordination

(1) How to handle requests for disclosure of estimated financial inputs by Japan?

According to the draft guidelines prepared by Planning and Coordination Department of JICA, "it is possible to disclose, at the discretion of JICA's overseas office, indicative financial inputs over multiple years to an individual JICA-supported project whose implementation is officially adopted by the government of Japan." Types of projects for which JICA is able to disclose such indicative inputs are technical cooperation projects, development surveys, dispatch of experts, training, provision of equipment, JOCV, follow-up cooperation, basic design studies for grant aid. However, in case of grand aid and small-scale grant aid, discussions and agreement between Embassy of Japan and a JICA overseas office regarding detailed disclosure procedures, disclosure projects, expenditure items for disclosure (for example, some JICA overseas offices opt not to disclose personnel costs of Japanese experts) should be made before disclosing the financial information. It should be noted that when the draft guidelines will be finalized, the range of discretion of JICA overseas office will be defined.

In the past, there were many operations and projects whose actual expenses were only captured at JICA Headquarters. Recent introduction of JICA-WAN makes it possible for JICA overseas office to retrieve such expense information, thus transaction costs to compile an expenditure report for disclosure should be low.

Because each recipient country employs different a budget process, establishment of financial information reporting procedures should be based on detailed studies and discussion with recipient government's finance ministry. Following are good examples of financial information disclosure:

It is possible to disclose, at the discretion of JICA's overseas office, indicative financial inputs over multiple years to an individual JICA supported project which is officially adopted by the government of Japan.

Discussions and agreement between an Embassy of Japan and a JICA's overseas office regarding detailed disclosure procedures should be made before disclosing financial information.

Case study Uganda (fiscal year is from July to June)

In Uganda, donors are requested to report and indicate financial information of aid for three years for the purpose of effective formulation and implementation of the national budget (to obtain the optimal allocation of external funds), and stabilization of macro economy. In October, when budget formation is initiated, the Ministry of Finance, Planning, and Economic Development requests financial aid information. In response to this request the donors inform amounts of their support by project (for project-type cooperation), and annual total amount of aid (in US$ million) by sector. This reported information will form part of the budget (on budget of external aid), and be used to determine sector ceilings. Donors are also requested to report settled amounts of aid of the past three years in order to confirm actual amounts of external aid provisionally reported last year.

However, reporting criteria (treatment of amount not disabused in Uganda, expenditures of cross-cutting sector programs, in-kind contribution, etc.) are not detailed enough, and donors request Ministry of Finance, Planning, and Economic Development to compile more comprehensive guidelines.

The Embassy of Japan financial report does not include expenditures made outside of Uganda (for example, costs incurred by dispatch of experts). Uganda is informed of the reasons for this decision: since expenditures are made outside of the country they do not influence macroeconomic stability of the country, and the difference in unit cost per expert service may draw unnecessary attention from other donors.

Case study Tanzania (fiscal year is from July to June)

In Tanzania, donors are requested to report information on financial flows of aid to Department of Budget and Department of External Finance in the Ministry of Finance in order to appropriate estimated expenditures in the budget, to complete reports of settlement, and to capture inflows of external resources.

From the point of view of predictability of budget, donors report aid plans to Ministry of Finance for the purpose of appropriation of external resources (on-budget). When it was noticed that projects were reported which were not included in the national budget, a survey was conducted to propose how to eliminate this kind of mistake. JICA, in collaboration with the Embassy of Japan, compiles the report based on the following proposed procedures currently under discussion.

1) In September, donors request generation of a project code of new project which is to be implemented from next fiscal year to the budget department of each line ministry
2) In February, the donor informs ministries of planned amount of expenditures for each project, some may ask donors about the latest amounts for the purpose of adjustment
3) For donor-assisted projects included in the approved budget announced in July, donors inform concerned ministries of expenditures incurred every quarter. Based on this expenditure report, the ministries draft dummy requests of payment to process the expenditures at the Ministry of Finance

The third procedure is necessary to settle accounts included in the budget. Currently, JICA office reports amounts of grant aid committed by the Exchange of Notes, local operation costs of project type cooperation and development survey, and costs of local training, etc. In the report, the costs which are expected to be spent in Tanzania are estimated for the next three years as precisely as possible.

JICA reports the actual quarterly-based expenditures following the format designated by Department of External Finance, and all expenditures related to all projects supported by Japan. These projects include small-scale grant aid, and also projects that are not cited in the budget.

4-2-4 Miscellaneous

(1) How should we respond to comments that donors not providing general budget support do not assist with PFM?

Some donors provide primarily general budget support to recipient government to help it implement PRSP. General budget support is a type of aid that not only provides a country with direct financial support, but also aims to strengthen the country's PFM. Donors transfer aid money into government accounts and the government uses it to achieve objectives of PRSP. Developing country receives practical training in using these funds, and the donor monitors and evaluates their application. In other words, countries receiving general budget support need PFM skills to some extent. This is why donors providing general budget support also provide technical assistance in the field of PFM.

Donors providing general budget support also provide technical assistance in the field of PFM.

Not only donors who provide general budget support are interested in PFM, but also those who provide project support only. If a counterpart organization fails to manage its project budget, the project will not succeed. A project in the agricultural sector cannot be managed properly if the ministry of agriculture is not able to secure government's budget for the project, or is not able to disburse its funds as planned. Thus it is necessary to strengthen PFM capacity of counterpart organization to secure project sustainability.

PFM is also important to donors who only provide project support.

With a few exceptions, Japan does not provide general budget support. However, it did provide debt relief for HIPCs in the amount of approximately 335.9 billion yen (1999). This debt relief was granted despite opposition from the Japanese public, so Japan needs to assist these countries not to build up debts again. Therefore, it is essential it supports PFM. Japan also provides financial support through the World Bank's PRSC. Since Japan makes a large contributions to PRSC and World Bank's Board of Executive Directors (one director represents the government of Japan) approve the PRSC, supporting PFM in HIPCs is the responsibility of Japanese development assistance.

Japan must work to ensure that HIPCs do not build up debts again, and this makes it essential that it supports PFM.

Case study Tanzania's PFM reform program

Japan including 11 donors provide general budget support to Tanzania. PFM reform program (PFMRP) is being implemented, covering a wide range of areas from the government's macroeconomic operations to general PFM involving ministries and agencies other than the ministry of finance. The program establishes and carries out action plans for each of ten program components. Previously, donors provided aid separately in each component. Currently aid is being carried out based on plans approved by Policy Committee established by the government and donors. There are two kinds of donor assistance: budget support deposited in a basket fund through the government's financial management system and other aid. The latter type is used to support projects in plans approved by the Committee.

The important issue here is that donors work together to provide aid within the framework of the PFMRP led by the Tanzanian government, and not whether the money is put into a basket fund or technical cooperation is chosen as the modality.

JICA began conducting a development survey in the PFM field in Tanzania in 2005. The development survey is intended to train staff in the "Treasury management and accounting" component, which is one of ten (10) components of PFMRP.

A

Accountability

This term refers to the obligation that those carrying out policies and projects have to provide an adequate and accurate explanation to stakeholders (citizens of one's own country and partner country and organizations in the case of aid) of the project's objectives, content, finances, results and decision-making process. ("Understanding Aid Trends")

Accountability means that not only must budget officials and sector ministries provide explanations as to their use of funds, but must also bear responsibility for erroneous use of capital. (DFID, 2001)

Accrual accounting

A financial accounting and measurement system whereby financial transactions are accounted when a transaction of economic event occurs regardless of the timing of the related cash receipt or payment. Accrual accounting reports on the economic resources or assets and liabilities of the entity. It requires the capitalization of expenditures on the acquisition of all capital assets and the depreciation of all assets as their service potential is consumed.

Modified accrual accounting is also not contingent on the timing of related cash flows. However, unlike full accrual, there is not deferral of costs of resources that will be consumed in future periods; physical assets that will provide services over a future period are "written off" in the period acquired. Therefore, expenditures (rather than expenses) reflect the cost of resources acquired and/or transferred during the period rather than the cost of resources consumed during that period. (ADB, 1999)

Alignment

Alignment ensures consistency with the recipient country's national development strategies and budget process. (Ministry of Foreign Affairs, "Japan's Action Plan to Improve Aid Effectiveness," 2005)

In the past, donors implemented their aid programs without coordinating with the programs of the recipient country or other donors, but it is now generally recognized that alignment under the country's ownership would enhance aid effectiveness, and that donor aid should be consistent with the recipient country's policies and systems such as PRSP. (JICA, Annual Report 2004)

The "Paris Declaration" (2005), which outlines efforts to improve aid effectiveness, calls for more aid alignment. To live up to this declaration, Japan's action plan emphasizes improvements to aid alignment. (Ministry of Foreign Affairs, "Summary and Evaluation of Paris High-Level Forum to Improve Aid Effectiveness")

APR (Annual Progress Report)

Developing countries prepare annual progress reports every year after PRSP are established to report on the progress made. The report analyzes economic conditions during the year and outlines and evaluates the implementation of PRSP, and policy and system reforms. (JICA's "Case Studies in the PRSP Process: Experiences in Tanzania, Ghana, Vietnam and Cambodia," 2004)

Annual Progress Review, APR

See APR.

Arrear

An obligatory payment by a debtor to a creditor that is not made by its due-for-payment date, including any grace period.(IMF, 2002)

Asset

An entity over which ownership rights are enforced by institutional units, individually or collectively, and from which economic benefits may be derived by its owners by holding it or using it over a period of time.(IMF, 2002)

Audit

Expert examination of financial compliance or performance, carried out to satisfy the requirements of management (internal audit), or an external audit entity, or any other independent auditor, to meet statutory obligations (external audit). A particular task of internal audit is to monitor management control systems and report to senior management on weaknesses and recommend improvements. The scope of audits varies widely and includes:

- Financial audits, covering the examination and reporting on financial statements, and the examination of the accounting systems upon which those statements are based;
- Compliance or regularity audits, which examine legal and administrative compliance, the probity and propriety of administration, financial system and systems of management control; and
- Performance audit/value for money audits, which assess the management and operational performance (economy, efficiency and effectiveness) of public programs, and of ministries and agencies in using resources in meeting specified objectives. (ADB, 1999)

B

Budget Support

Donors deposit money into the treasury or other account designated by the recipient government, and the government and donors jointly manage the use of funds and outcomes. It is important that the money be used in accordance with the government's system to improve public financial management capabilities. Aid in which the money's application is not limited is called "general budget support," and earmarking money for a specific budget item or sector is called "sector budget support." (based on "Understanding Aid Trends" and the JICA website)

With sector budget support, the donor country and developing country's government agree to earmark the money for use in a specific sector. Sometimes it is designated for use in a sub-sector (for example, primary education in the education sector). (JICA, "Financial Management and Aid in Developing Countries," 2003)

C

Capital expenditure

Expenditure for acquisition of land, equipment, other physical and intangible assets, government stocks, and nonmilitary, nonfinancial assets, of more than a minimum value and to be used for more than one year in the process of production. All expenditures that are not capital are "current." (ADB, 1999)

CAS (Country Assistance Strategy)

CAS is the World Bank's three-year business plans created to support the borrowers' programs. The World Bank prepares CAS every three years for each country in consultation with country authorities, the IMF, development partners, the United Nations, bilateral organizations, the private sector and civil society organizations. (from website of World Bank's Tokyo office)

Cash-based accounting

An accounting method that records cash receipts, payments, and balances. The cash basis of accounting recognizes transactions and events only when cash has been received or paid. For revenue, data should represent payments received by government, net of refunds paid out, during the period covered. For expenditure, checks paid or issued or cash disbursed represent the most desirable basis on which to depict the government's financial transactions reconcilable with the monetary accounts. When data cannot be obtained on this basis, statistics based on warrants issued, payment orders, or deliveries are an acceptable measure of government expenditure (also referred to as payments basis of accounting).

The modified cash basis recognizes as disbursements in a reporting period those amounts expended during the reporting period plus those cash flows in a specified period following the reporting date (e.g., 60 days) that relate to events or transactions incurred during the reporting period. Analogously, cash flows of the first 60 days of the reporting period that relate to the previous reporting period are deducted. In effect, the modified cash basis "leaves the book open" after year-end to identify payables. Sometimes those amounts are set up as liabilities at year-end. In other cases, they are simply recorded as disbursements of the period, even though they are not paid until after the end of the period. Therefore, it is still reporting disbursement (flows of cash), rather than expenditures. The modified cash basis fails to identify or record the accrual of any long-term liabilities, such as pension liabilities. (ADB, 1999)

CDF (Comprehensive Development Framework)

This concept advocates a comprehensive approach based on the country's ownership for its own development and participation from a broad range of sectors. CDF's basic concept is as follows:

- The country itself develops its development agenda with ownership of measures to address them. The World Bank and other donors participate in developing the CDF and provide strategic aid under a common plan of operations.
- The CDF emphasizes the creation of a strong partnership between the government, donors, civil society, the private sector and other development organizations. (from website of World Bank's Tokyo office)

Central bank

The public financial corporation that is a country's monetary authority. It issues currency; has liabilities in the form of demand or reserve deposits of other depository corporations, and often the government; and may hold all or part of the international reserves of the country.(IMF, 2002)

Central government

The government whose political authority extends over the entire territory of the country. The central government can impose taxes on all resident institutional units and on nonresident units engaged in economic activities within the country. Typically it is responsible for providing collective services for the community as a whole, such as national defense. In addition, it may provide services for the benefit of individual households, such as health and education, and it may make transfers to other institutional units. (IMF, 2002)

CFAA (Country Financial Accountability Assessment)

The CFAA assesses the systems and organizations used to fulfill accountability requirements as regards public sector finances and private-sector financial conditions. The World Bank designed this assessment method to deepen knowledge about financial accountability in the public and private sectors. (DFID, 2001)

CFAAs evaluate a country's financial management system and private-sector financial standards. It stresses the management aspects of finance more than PER does. The Board of Directors uses the CFAA when screening countries for the World Bank's PRSC. Because of the broad range of the analysis, the CFAA is prepared jointly by economists and financial specialists at the World Bank. (JICA, 2004)

Common Fund

A common fund is a fund set up by the recipient country's sector ministry based on the sector development plan prepared in consultation with the public and donors. The fund consists of aid money given by donors without restricting its use to a specific project and money given by the recipient country's government. The fund is managed in accordance with agreements between the donors and the government. (JICA, "Case Studies on the PRSP Process: Experiences in Tanzania, Ghana, Vietnam and Cambodia," 2004)

Conditionality

In general, conditionality refers to the implementation of specific measures and infrastructure to facilitate aid implementation that donors demand as a condition for providing aid. For example, the IMF requires that the borrowing government carry out economic adjustment programs as a condition for the loan. This economic adjustment program serving as a condition for the loan is called a conditionality. The program consists of macroeconomic policies, and outlines specific measures to reduce the fiscal deficit, reduce the trade deficit, cut public subsidies, lower the exchange rate and carry out fiscal reforms. (International Development Journal, International Cooperation Glossary, 1998)

Cost-effectiveness

The extent to which policy and program objectives are achieved at minimum economic cost: synonymous with value for money. (ADB, 1999)

Counterpart fund under KR or 2KR scheme

This is a system under which the recipient country is required to make deposits into a fund in exchange for specific types of grant aid cooperation from Japan, namely Food Aid (KR), Grant Aid for Increased Food Production (2KR) and grant aid to support economic structural reforms (non-project grant aid). ("Understanding Aid Trends")

The recipient country sells the materials and equipment provided through Food Aid (KR) and Grant Aid for Increased Food Production (2KR), and an amount equivalent to the sales price-or in some poor countries an amount equivalent to 1/3 - 2/3 the sales price-is deposited in the recipient country's bank account as local currency for use in socioeconomic development. This local currency is called "counterpart funds," and the socioeconomic projects that the recipient government carries out using the counterpart funds are called "counterpart fund projects." (JICA, "Basic Research Report on Methods for Planning and Implementing Grant Aid for Increased Food Production (2KR)," 2003)

CPAR (Country Procurement Assessment Report)

The CPAR is a tool developed by the World Bank that is used to assess public procurement independently of the CFAA. (DFID, 2001)

The CPAR evaluates the reliability of the recipient country's procurement system. Financial management specialists at the World Bank are primarily responsible for these reports. (JICA, 2004)

D

Debt cancellation / debt forgiveness

The cancellation of a debt (or part of a debt) by mutual agreement between a creditor and debtor.(IMF, 2002)

Debt rescheduling

A bilateral arrangement to alter the dates for servicing an existing debt, usually on terms more favorable for the debtor and possibly with partial debt forgiveness, including extending repayment schedules, adding or extending grace periods for interest and principal payments, or rescheduling debt service payments that are in arrears.(IMF, 2002)

Debt restructuring

A bilateral arrangement to alter the terms for servicing an existing debt, often on more favorable terms for the debtor and possibly with partial debt forgiveness. In addition to debt rescheduling, debt restructuring can include the replacement of the existing debt with a new debt. (IMF, 2002)

Debt sustainability

Debt sustainability refers to the government's management of debts so as to ensure that its debts do not impede economic growth and stability. (World Bank's website)

Some are of the opinion that debt sustainability should be defined as the level that allows a country to attain its MDGs (from the "Millennium Project Report"). The debt analysis at the end of phase 1 in the HIPC Initiative must show that the country's net present value debt-to-export ratio is over 150% on average for the following three years; this level is deemed sustainable. At this point, the debt burden at the completion point three years later is calculated using a stipulated debt rescheduling method. Countries expected to achieve sustainable debt levels by the completion point are eligible for debt relief. (Japan Center for International Finance, "IMF and World Bank's DSA Analysis," 2002)

Decision Point/Completion Point

Under the HIPC Initiative, at the decision point the international community agrees on the amount of debt relief to be given and the debt relief begins. At the completion point, all creditors unconditionally provide any debt assistance not yet provided. A country must have carried out all the main reforms and policies outlined in its PRSP in order to be considered as having reached the completion point. (World Bank's Annual Report 2004)

Countries reach the decision point after undergoing a three-year review process and have been deemed eligible for aid under the HIPC initiative (the first phase). At the decision point, a debt sustainability analysis is carried out and the World Bank and IMF formally decide on the country's debt relief program. At this point, the PRSP or I-PRSP must be submitted.

Debt relief measures will be provided for countries that have been deemed unable to sustain their debt payments at the decision point (phase two), and at the completion point the World Bank and IMF will make the final decision on whether to reduce debt on a stock basis depending on the success of these debt relief measures. (based on "Understanding Aid Trends")

Depreciation

The expense item in financial accounting that corresponds to consumption of fixed capital in the GFS system. It is normally calculated using the original costs of fixed assets, while consumption of fixed capital is calculated using the average prices of the assets in the current period. (IMF, 2002)

Discount factor

A number used to convert a future cash flow, such as a debt payment, to its present value. Normally, a discount factor is estimated as the amount that would have to be invested now, at an appropriate interest rate given the risk associated with the future cash flow, to generate an amount equal to the future cash flow. (IMF, 2002)

E

Earmark

When funds are earmarked, they are set aside for a specific activity or region.

With the earmark method, funds are given directly to a specific organization or to the local government for a specific project (a project or program in a specific area). These funds are either given directly to the organization carrying out the project and the organization manages revenue and expenditure, or the money is deposited in the finance ministry's treasury and expenditures are controlled via the partner country's budget process. (JICA website)

The flow of aid funds given to the ministry or department is recognized by the developing country and posted on its budget, but when the recipient is limited to a specific project, the use of the funds is predetermined and the developing country can follow the flow of the money. In all other respects, however, this method is the same as typical project aid. (JICA, "Case Studies on the PRSP Process: Experiences in Tanzania, Ghana, Vietnam and Cambodia," 2004)

Enhanced HIPC (E-HIPC) Initiative

In 1999, the international community endorsed enhancements to the HIPC Initiative allowing more countries to qualify for HIPC assistance, accelerating and deepening the delivery of relief, and strengthening the link between debt relief and poverty reduction. (World Bank's website)

Under the Enhanced HIPC Initiative, ODA loans can be entirely reduced (rather than just the original 67% reduction) through various options. The completion point is considered to have been reached when the conditions set at the decision point have been attained, rather than after a pre-determined period. (Ministry of Foreign Affairs, "Evaluation of System to Implement Aid in Tanzania," 2001)

Economic classification

The classification used to identify the types of expense incurred when a government supplies goods and services to the community or redistributes income and wealth. (IMF, 2002)

F

Fiduciary risk

Fiduciary risk refers to the risk taken on when there is no guarantee that money will be used as intended. When money is given through budget support, the money's use is not limited and is used in accordance with PRSP and other plans that developing countries have prepared. By shifting management of funds from the donor country to the developing country, the donor country is requiring that the developing country guarantee that it is used properly. The risk that appropriate use will not be guaranteed is known as "fiduciary risk." (JICA, "Fiscal Management and Aid in Developing Countries," 2003)

Fiscal discipline

Fiscal discipline refers to regulations needed to determine the structure of public finances such as the amount of money to be raised through public bond issuance and loans in order to offset the gap between total revenue and total expenditures. A government demonstrating fiscal discipline is one that relies on tax revenue for government spending in the medium to long term and runs its finances to ensure equitability. To ensure fiscal discipline, the amount of expenditures is estimated in advance during the budget process and spending is limited to a certain level.

Fiscal discipline is the management of finances to prevent the proportion of government debt to the private-sector economy from expanding and to ensure long-term sustainable fiscal operations. (Shizume, Fiscal Discipline and the Central Bank's Balance Sheet, 2001)

Fungibility

Fungibility refers to the diversion of funds allowing developing countries to use resources freed up by funds given by donors for development for purposes other than development. (Otsuka, 2004)

Functional classification

The classification used to identify the purpose, or socioeconomic objective, for which an expense was incurred or a nonfinancial asset was acquired. (IMF, 2002)

G

Government

The public authorities of a country and their agencies, which are entities established through political processes that exercise legislative, judicial, and executive authority within a territorial area. The principal economic functions of a government are (1) to assume responsibility for the provision of goods and services to the community on a nonmarket basis, either for collective or individual consumption, and (2) to redistribute income and wealth by means of transfer payments. An additional characteristic of government is that these activities must be financed primarily by taxation or other compulsory transfers. (IMF, 2002)

H

Harmonization

Previously, each donor used different aid practices, putting a greater burden on the developing country's government. Accordingly, donors now use the same aid practices to the extent possible to lessen the government's burden. (JICA, "Understanding Aid Trends," 2003)

In recent years, donors have emphasized the importance of harmonizing the measures and procedures used to implement aid in order to increase aid effectiveness and reduce the government's transaction costs. In the OECD-DAC, a task force was established in 2001 to review the possibility of harmonizing and simplifying aid practices. In March 2002 the International Conference on Financing for Development, held in Monterey, California, included the idea of harmonization in its joint statement. (GRIPS, "Harmonization of Aid Practices by JBIC, the World Bank and ADB in Vietnam," 2003)

Heavily Indebted Poor Countries

See HIPCs.

HIPCs (Heavily Indebted Poor Countries)

HIPCs are countries recognized by the IMF and World Bank as being the poorest and most heavily indebted. The criteria for qualification as an HIPC are (1) GNP below USD695 in 1993 and (2) net present value debt-to-export ratio in 1993 was more than 220% or net present value debt-to-GNP was more than 80%. (website of Ministry of Foreign Affairs)

HIPC Initiative

This is a framework proposed by the World Bank and IMF in 1996 under which all creditor countries reduce the debt of the world's poorest and most heavily indebted countries. This ensures that the debts of the HIPCs do not hold back their economic growth and attempts to reduce poverty. (World Bank's website)

Countries would be eligible for debt relief if they (1) are eligible for aid from IDA, (2) their debts remain unsustainable even after having applied traditional debt relief mechanisms and (3) they have had good results in the IMF/World Bank's adjustment programs. (JICA's "Basic Research on Poverty Reduction," 2001)

Unsustainable debt situations are defined as debt-to-export levels exceeding 150% or 250% for countries with very open economies. (World Bank's website)

Household

A person or small group of persons who share the same living accommodation, pool some or all of their income and wealth, and consume certain types of goods and services collectively, mainly housing and food. (IMF, 2002)

Households sector

The group of units consisting of all resident households. (IMF, 2002)

I

IDA (International Development Association) credit

The World Bank Group is made up of the International Development Association (IDA), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA), and International Centre for Settlement of Investment Disputes (ICSID). While the IBRD makes loans on a semi-commercial basis, the IDA loans are intended to provide poor developing countries that would be unable to borrow on their usual terms with loans on more relaxed terms. (Ministry of Foreign Affair's website)

IDA lends to countries that had an income in 2002 of less than USD865 per person and lack the financial ability to borrow from IBRD. Some "blend borrower" countries like India and Indonesia are eligible for IDA loans because of their low per person incomes but are also eligible for IBRD loans because they are financially creditworthy. IDA credits have maturities of 20, 35 or 40 years with a ten-year grace period before repayments of principal begins. IDA funds are allocated to the borrowing countries in relation to their income levels and record of success in managing their economies and their ongoing IDA projects. There is no interest charge, but credits do carry a small service charge, currently 0.75% on funds paid out. Most loans address basic needs, such as primary education, basic health services, and clean water and sanitation. IDA also funds projects that safeguard the environment, improve conditions for private business and build infrastructures. (World Bank's website)

IFMIS (Integrated Financial Management Information System)

IFMIS aims to use computers in the financial management process to facilitate the provision of necessary information and improve the appropriateness and speed of decision-making regarding PFM. Projects to introduce IFMIS generally include components such as classification and coding of budget items, training in the system's use, data preservation and security and formation of expenditure process. (World Bank's website)

Improving predictability

Improving predictability enhances the accuracy of the recipient country's estimate of the development aid it will receive from its donors.

In particular, aid predictability can be improved by including budget support in budgets through PER and MTEF. Further, this would help to ensure that the budget is allocated to priority areas with a medium to long-term perspective. (Ministry of Foreign Affairs)

For example, in Tanzania all donors inform the finance ministry of their aid commitments for the following year and their estimated aid for the following two years by October each year. The finance ministry allocates this assistance into a development budget and recurrent budget, and reflects this in the MTEF and the budget documentation. (GRIPS, "Selecting an Aid Modality and Japan's ODA Reforms 2005")

Although it is not illegal to give recipient countries rough estimates of aid amounts for several fiscal years (Ministry of Finance's opinion), Japan has not yet disclosed information taking advantage of these merits. For donors, it is important that aid projects are incorporated in plans reflecting sector measures, budget formulation and the MTEF. For example, if the project budget is shown in the government's budget, the transparency of the project's counterpart expenses and maintenance costs will be increased. Based on these estimations, a recipient government and donors can work closely to take measures early on ensuring the project's financial sustainability. (Study group's opinion)

In-kind aid

Rather than providing money, aid is provided in the form of material goods or human resources. (Ministry of

Foreign Affairs' website, "Japan's Cooperation in Africa as Shown in Numbers")

L

Liability

An obligation to provide economic benefits to the unit holding the corresponding financial claim. (IMF, 2002)

Loan

A financial instrument that is created when a creditor lends funds directly to a debtor and receives a nonnegotiable document as evidence of the asset. (IMF, 2002)

M

MDGs (Millennium Development Goals)

The Organization for Economic Cooperation and Development (OECD), International Monetary Fund (IMF) and World Bank established the development goals at the Millennium Summit in 2000 which were included in the 2000 UN Millennium Declaration. The goals include the eradication of extreme poverty and hunger to half of 1990 levels by 2015 and attaining a 100% primary school attendance rate. (Ministry of Foreign Affairs' website)

MTEF (Medium-term Expenditure Framework)

The MTEF is a three-year plan for public spending and funding. (JICA's "Understanding Aid Trends," 2003)

MTEFs are three-year national fiscal plans prepared by the recipient country's finance ministry, and include a macroeconomic analysis. MTEFs allocate funds to fit sector development plans, thus providing a process by which a limited budget can be effectively allocated. MTEFs are intended to ensure (1) macroeconomic balance, (2) strategic budget allocation and (3) efficient budget execution. (JICA's "Basic Research on Poverty Reduction," 2001)

MTEFs serve as the government's investment plan for the budget year and several years after. MTEFs aim to (1) establish a rolling plan with a medium-term (three to five years) perspective, (2) ensure that Cabinet and central government as well as local governments maintain fiscal disciple and allocate public resources strategically in accordance with priorities and (3) integrate the budget ceiling set with a top-down approach and the costs calculated with a bottom-up approach. (JICA, "Financial Management and Aid in Developing Countries: New Aid Trends and Reforms in Developing Countries," 2003)

N

NEPAD (New Partnership for Africa's Development)

NEPAD is a platform developed by the African Union (AU) for establishing comprehensive development strategies for Africa. Based on the concepts of this initiative, self-help and own responsibility in a complete overhaul of the previous reliance on aid from developing countries, NEPAD is intended to lead to the development of comprehensive development strategies for Africa. This strategy emphasizes peace, democracy, human rights, good governance and sound economic management and aims to raise the economic growth rate to 7% by 2015. Many donors provide NEPAD with financial support to adjust and establish plans. (JICA's "Understanding Aid Trends," 2004)

Net present value (NPV) of debt

The net present value is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the market interest rate. When loans are taken out at a rate lower than the market rate, the NPV is lower than the face value of the debt, and the amount below the NPV is forgiven as a grant. (IMF, "HIPC Initiative (Fact sheet)," April 2003)

New Public Management (NPM)

NPM is a type of management reform using private-sector management methods in the public sector. The NPM approach is characterized by an emphasis on results (not merely using up the budget, but generating the best results possible), emphasis on customers (not limiting focus to laws and regulations, but carrying out management from the perspective of the citizens-the customers), principle of competition (privatization, outsourcing, separation between the departments in charge of drafting policy and the departments in charge of executing policy), decentralization (organization based on transfer of authority), and achievement assessment (improving operations using achievement assessment and feedback as well as ensuring accountability). (Eguchi, 2000)

O

Offset method

When the recipient country determines the government division's budget (or the budget to be allocated to local governments), an amount equivalent to donor aid (cash or in-kind) is deducted from the budget allocated by the government. This method attempts to redress any imbalances between sectors and regions receiving significant amounts of aid from donors and those that do not.

Off-budget

Off-budget refers to aid funds that are not recorded in the recipient government's budget. (JICA's "Understanding Aid Trends")

Separating aid money from the recipient government's budget makes it easier for the donor to control the aid money and to meet its accountability responsibilities vis-a-vis its own country. On the other hand, this method forces the recipient government to manage the funds on a project-by-project basis, thus increasing the administrative work involved and making it difficult to ascertain the national and sector budgets. (JBIC's Research Institute for Development and Finance, "Development Aid as Foreign Policy," 2004)

On-budget

On-budget refers to the practice of recording aid funds as part of the budget prepared by the recipient government. If all aid funds received from donors are recorded on the government's budget, the government can ascertain the amount of funds injected and can address fungibility issues. On-budget practices raise the transparency of development and investment funds, promote good governance and enhance aid efficiency. (JICA's "Understanding Aid Trends")

By ensuring that aid funds are on-budget, aid funds are included with the government's revenue and expenditures, and the aid funds are recorded as budgetary expenditures. This enables the government to manage its national finances, including aid funds, in a comprehensive manner. (JBIC's Research Institute for Development and Finance, "Development Aid as Foreign Policy," 2004)

P

PAF (Performance Assessment Framework)

PAF is a matrix including the primary policies, activities and output that is prepared to monitor and assess PRSP implementation. (from Strategic Partnership with Africa website)

It is not a mere list of conditionalities, but instead outlines specific policies to achieve the PRSP objectives. For example, the World Bank evaluates execution of the PRSP based on the PAF and makes its decisions on PRSC after confirming that a PAF for the next fiscal year has been established.

Paris Club

The Paris Club is an informal group of financial officials from creditor nations that discuss issues of public debt. It grew out of talks held in Paris in 1956 to discuss extensions for Argentina's delinquent external debt. (NEXI website)

The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the repayment difficulties experienced by debtor nations. The Paris Club consists of 19 permanent members who agree to reschedule or reduce debt service obligations. (Paris Club website)

PEFA (Public Expenditure and Financial Accountability) program

PEFA is not the common name for documents such as those described above, but is a program to which the World Bank, EC (EU), IMF and DFID have contributed and whose executive board is made up of the contributing countries and organizations as well as the Strategic Partnership with Africa (SPA). PEFA aims to consolidate the various assessment tools that have been developed by organizations thus far and use a more comprehensive approach. It has carried out pilot assessment programs in 10-20 countries. It also attempts to provide a framework bringing together the PER, CPAR and CFAA. (JICA, 2004)

Pension fund

A fund established for the purpose of providing benefits on retirement for specific groups of workers, dependents, and other beneficiaries. A pension fund can be a separate institutional unit (an autonomous pension fund) or the assets, liabilities, transactions, and other events of the pension fund may be included among the corresponding items of the employer operating the scheme (a nonautonomous pension fund). (IMF, 2002)

PER (Public Expenditure Review)

PER is a report which presents analyses of public expenditures of a recipient country. Although PER is usually compiled by the World Bank, some PERs are outcomes of collaborative work of the recipient government, the World Bank and other donors.

PERs analyze and evaluate policy implementation with a macroeconomic perspective to determine whether resources are allocated efficiently and effectively. Typically, the analysis focuses on these six points: (1) prediction and analysis of government revenue, (2) breakdown of government expenditures and the amounts to be spent, (3) evaluation of allocations between sectors and within sectors, (4) review of publicly-managed corporations, (5) review of governance structure and (6) review of functions and efficiency of public organizations. An increasing number of PERs focus their analysis on several main topics, but at a minimum PER must cover the following topics: (1) the public sector most important to the country in question, (2) overall resources, including aid, and (3) scope of past reports.

A wide range of participants, including donors, are required to carry out a PER. In particular, it is crucial to receive commitments from people with the authority to determine policies so as to ensure that the reform proposals made in the PER will be accepted. (Taichi Sakano and Masafumi Aoki, "Developing Countries and Public Financial Management," 2000)

The government of Tanzania conducts Public Expenditure Review which has the same name but is different from the one by the World Bank. This Tanzania's PER examines activities of the public sector and government expenditure. The PER takes place with the participation of donors every year.

Performance Budgeting

This is a method by which the budget is allocated to implement certain policies and measures to achieve output as indicated by targets. (Japan Research Institute, "NRI Public Management Review," 2004)

The objective of performance budgeting is to serve as a platform from which to review the relevance of the input and the outcome by incorporating information on the amount of money to be applied and the intended outcome in the budget. When attempting to introduce performance budgeting to a developing country, the country's capacity must be scrutinized first. (JICA, "Financial Management and Aid in Developing Countries: New Aid Trends and Reforms in Developing Countries," 2003)

PRBS (Poverty Reduction Budget Support)

PRBS is a fund that provides budget support to assist with policies and programs intended to boost economic growth, reduce poverty, reinforce tax collection and organizations and improve abilities to form budgets (abilities related to policy formulation, financial management, procurement and accountability). (DFID website)

Predictability

Predictability of financial resources is needed for strategic prioritization and to permit public officials to plan for provision of services to keep them from avoiding responsibility for nonperformance. Predictability of government expenditure in the aggregate and in the various sectors is also needed as a signpost on which the private sector can rely to make its own production, marketing, and investment decisions. (ADB, 1999)

PRSP (Poverty Reduction Strategy Paper)

The PRSP consists of comprehensive, long-term poverty reduction strategies and policies prepared by the developing country itself in a participatory process.

In light of discussions on poverty reduction and debt reduction at the G7 summit in 1999, at its general meeting held the same year the World Bank and IMF decided to require that all HIPCs and all countries receiving IDA loans prepare PRSP to speed up the reduction of poverty in low-income countries. The World Bank views the PRSP as a plan that transforms its concept advocating a comprehensive development framework (CDF) into action. (website of World Bank's Tokyo office)

PRSPs are owned by the government but created with participation from a wide range of people, including donors, NGOs, citizens and the private sector. ("Understanding Aid Trends")

Countries eligible for the enhanced HIPC Initiative must prepare a PRSP by the decision point and receive the support of the World Bank and IMF executive boards, but in the case of insuffcient time an Interim PRSP (I-PRSP) can be prepared instead. The full PRSP (F-PRSP) must be approved by the World Bank and IMF executive boards by the completion point. (Ministry of Foreign Affairs' website)

PRSC (Poverty Reduction Support Credit)

The PRSC is the new name for the World Bank's original Structural Adjustment Credit (SAC) loan program, and was introduced in 2001 to correspond to the PRSP.

While previous SAC did not use the term "budget support," PRSC is clearly intended to be a form of budget support. While the World Bank's previous policy support loans, including SAC, focused primarily on short-term macroeconomic stability, PRSCs focus on medium-term social and organizational reforms, with a much higher proportion of the aid going to the public sector and social sector. Also, while it is similar to the previous SAC in that they impose conditionalities such as policy and organizational reforms, the previous policy support loans imposed ex-ante conditionalities such as policy reforms, while the PRSC imposes ex-post conditionalities. PRSCs emphasize the outcome in order to foster the developing country's sense of ownership. (JICA, "Case Studies on the PRSP Process," 2004)

Unlike typical structural adjustment loans, the PRSCs are broken down into multiple units to correspond to the recipient country's budget cycle in order to support national strategies over a longer time span. (Ministry of Economy, Trade and Industry's website)

PRGF (Poverty Reduction and Growth Facility)

PRGF is the IMF's loan program for low-income countries with balance of payment problems that are implementing structural adjustment. The IMF provides low-income countries with long-term (10 year repayment period and 5.5 year grace period) loans at low interest rates (0.5%). The program is in a separate account from other IMF loans, and is run with loans from member countries and interest rate subsidies. In October 1999 the loan program's name was changed from Enhanced Structural Adjustment Facility (ESAF) to PRGF. (Ministry of Finance's website)

Programs receiving support through the PRGF (PRGF programs) emphasize stronger governance and use macroeconomic policies to reduce poverty and influence socioeconomic conditions. (IFM website)

Countries receiving PRGF as well as HIPCs must establish PRSP. (JICA's "Understanding Aid Trends," 2003)

S

SDR (Special Drawing Right)

See Special Drawing Right.

Sector-wide Approaches (SWAps)

This development approach attempts to resolve the inefficient use of human and financial resources caused by duplicate aid from donor countries and inadequate consistency between the aid and the recipient country's development plan. The recipient country takes a central role in this approach and prepares a development plan for each sector, and the recipient countries and donors adjust aid in accordance with these plans. This approach is particularly common in Sub-Saharan Africa. (Ministry of Foreign Affairs' website; "Aid Plan for Cambodia")

A SWAp is characterized by (1) a single policy framework that is shared by donors and recipient country, (2) a single, shared medium-term expenditure framework, (3) financial backing (contributions from either the government itself or the donors), (4) monitoring and evaluation, and (5) formulation and implementation process in which the recipient government leads the coordination efforts between stakeholders. (IDCJ, "Introduction to Sector Programs," 2005)

The SWAp has attracted considerable attention in response to the realization that the conventional method in which donors fail to work together in coordinating their individual projects failed to adequately generate a spillover effect and that it increased the recipient country's transaction costs and led to uncontrolled, excessive aid. This is also known as sector programs (SPs). (Ministry of Foreign Affairs, "Overseas Development Assistance (ODA) Country Data Book," 2004)

Social security fund

A government unit devoted to the operation of one or more social security schemes. To satisfy the general requirements of an institutional unit, the fund must be separately organized from the other activities of government units, hold its assets and liabilities separately, and engage in financial transactions on its own account.(IMF, 2002)

SPA (Strategic Partnership with Africa)

The SPA is a special aid framework established at the World Bank's initiative in December 1987 and is made up of multilateral aid organizations and bilateral aid organizations. It is intended to support the structural adjustment efforts of low-income countries in Sub-Saharan Africa suffering from their cumulative debts. It has become a forum for discussions on wide-ranging aid practices (modalities), including budget support. ("Understanding Aid Trends")

Special Drawing Right (SDR)

An international reserve asset created by the IMF and allocated to its members to supplement existing reserve assets. SDRs are held only by the monetary authorities of IMF member countries and a limited number of authorized international financial institutions. An SDR represents an unconditional right to obtain foreign exchange or other reserve assets from other IMF members. It is a financial asset for which there is no corresponding liability, and the members to whom they have been allocated do not have an unconditional liability to repay their SDR allocations. (IMF, 2002)

Structural Adjustment

Structural adjustments are economic reform policies based on market economy mechanisms that the IMF and World Bank impose on countries it lends to. Deterioration in developing country's economies, as evidenced by Mexico's debt crisis in 1982, would lead to excessive government intervention to market that distorts economic rationality. The structural adjustment was an attempt to address these distortions. Within a short period structural adjustment measures aimed to privatize government-managed companies, abolish price-setting of agricultural products, the privatization of grain monopolies and creation of a competitive market, and the abolition of inhibitive customs duties. These policies caused dramatic changes in markets and overall forced the most economically weak to suffer the greatest burden.

Subsidy

An unrequited payment by a government unit to an enterprise based of the level of its production activities or the quantities or values of goods or services it produces, sells, exports, or imports. Subsidies may be designed to influence levels of production, the prices at which outputs are sold, or the remuneration of the enterprises. Included are transfers to public corporations and other enterprises that are intended to compensate for operating losses. (IMF, 2002)

T

Tax

A compulsory transfer to the general government sector. Certain compulsory transfers, such as fines, penalties, and social security contributions, are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative taxes. Fees that are clearly out of all proportion to the costs of providing services are included. (IMF, 2002)

Transparency

Transparency of fiscal and financial information is a must for an informed executive, legislature, and the public at large (normally through the filter of competent legislative staff and capable public media). It is essential not only that information be provided, but that it be relevant and in understandable form. The IMF has assembled in 1998 a Code of Good Practices on Financial Transparency, which underlines the importance of clarity of fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information, and accounts. (ADB, 1999)

V

VFM (Value for Money)

The value for money concept advocates the greatest possible outcome (public services) for the input (tax payments). The concept was first used to refer to the objective of fiscal reforms pushed by the Thatcher administration in the UK.

This concept advocates searching for a method by which the government can provide higher quality services with the same input and provide cheaper services with the same quality services. When comparing two projects with the same purpose, higher VFM will be achieved with the project that provides better quality services for the same costs or lower costs for the same quality services. (JICA's "Research Report on Public-Private Partnership (PPP) Project")

W

Wages and salaries

All compensation of employees except for social contributions by employers. Included are payments in cash or in kind. Social contributions paid by deduction from employees' wages and salaries are included in wages and salaries. Excluded are reimbursements of expenditures made by employees in order to enable them to take up their jobs or to carry out their work, such as expenditures on tools, equipment, special clothing, or other items that are needed exclusively or primarily to enable them to carry out their work. Also excluded are social benefits paid by employers. (IMF, 2002)

Sources of Information - Websites

The following sources of information have been referred to for the compilation of this handbook. They should be useful for readers who are/will be involved in PRS processes and PFM assistance.

1. World Bank website

On the World Bank's website (http://www.worldbank.org/) PFM references such as Public Expenditure Review documents (PERs), Country Financial Accountability Assessment (CFAA), Country Procurement Assessment Report (CPAR), etc. can be found. Note that CFAA and CAPR for particular countries are not disclosed. The following publications are referred to in the development of this handbook:

Operation Evaluation Department, 2003, "The Heavily Indebted Poor Countries (HIPC) Debt Initiative -an OED review-," Report No. 25160, (Washington: World Bank).

Public Expenditure and Financial Accountability Secretariat, 2005, "Public Financial Management Performance Measurement Framework," (Washington: World Bank).

World Bank, 1998, "Public Expenditure Management Handbook," (Washington: World Bank).

World Bank, 2001, "Public Expenditure Management and Accountability: Evolution and Current Status of World Bank Work," (Washington: World Bank).

World Bank, 2002, "Reforming Public Institutions and Strengthening Governance: A World Bank Strategy," (Washington: World Bank).

Based on categorization used on the website, brief explanations of information sources within the website are introduces below:

Countries category: Publications and data in this category are arranged country-by-country. For example, the webpage Project Appraisal Reports related to Kenya can be accessed through the Publications & Report, and Project & Programs hyperlink on Kenya. From Analytical & Advisory Work hyperlink, PER can be accessed. Information regarding details of PFM reform programs, their implementation status, issues, aid coordination frameworks established between government and donors can be obtained from these publications.

In Countries category, various reports related to Consultative Group Meeting[47] (CG Meeting) are grouped. Exchanges between a government and donors are particularly well documented. Because the World Bank is secretariat of these CG Meetings, the site holds the latest documents and proceedings. For example on Kenya's site, materials of CG Meeting held in April 2005 can be obtained, which are difficult to obtain from other sources.

Topics category: In this category, basic knowledge, theories, trends in related organizations and scientific societies, case studies, and project evaluation reports related to specific discipline fields can be accessed. These

[47] CG Meeting is organized to facilitate policy dialogues and aid coordination among the recipient country and bilateral and multilateral donors concerned. In the meeting, information on economic conditions, development plans, and development projects of the country is shared among participants, and donors may make pledges to provide aid. (Source: Ministry of Foreign Affair's website)

topical sites are financed by the World Bank, other aid agencies, organizations in developing countries, universities, and research groups, and administered by members of these organizations. Therefore, information from these topical sites also indicate the network of people and organizations active in these fields.

Below are listed sites on the World Bank website related to PFM directly or indirectly.

Topic Sites on the World Bank Website

Topic	Web address
Administrative & Civil Service Reform	http://www1.worldbank.org/publicsector/civilservice/
Administrative & Civil Service Reform (governments)	http://www1.worldbank.org/publicsector/civilservice/government.htm
Debt Issues: HIPC, Relief, Sustainability	http://www.worldbank.org/debt
Decentralization	http://www1.worldbank.org/publicsector/decentralization/
Estimated Debt Service Reports	http://www.worldbank.org/edsr
Harmonization	http://www1.worldbank.org/harmonization/romehlf/
Heavily Indebted Poor Countries	http://www.worldbank.org/hipc
Millennium Development Goals	http://www.developmentgoals.org/
Poverty Reduction Strategy	http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPRS/0,,menuPK:384207~pagePK:149018~piPK:149093~theSitePK:384201,00.html
Public Debt Management	http://www.worldbank.org/pdm/
Public Expenditure	http://www.worldbank.org/publicsector/pe/index.htm
Public Sector Governance	http://www1.worldbank.org/publicsector
Tax Policy and Administration	http://www1.worldbank.org/publicsector/tax/

2. IMF and Paris Club websites

On the IMF website (http://www.imf.org/external/index.htm) materials related to economic, fiscal, and financial policies can be obtained. IMF also maintains time series data defined by Government Financial Statistics Classification, and data on governments' debts[48] can be viewed on its website.

Most information on debt can be obtained on the IFM website. However, to obtain information on detailed bilateral debts, the Paris Club website (http://www.clubdeparis.org/en/index.php) needs to be consulted.

The following IMF documents are referred to in the development of this handbook:

Independent Evaluation Office, 2004, "Evaluation of the IMF's Role in Poverty Reduction Strategy Papers and Poverty Reduction and Growth Facility," Evaluation Report, (Washington: International Monetary Fund).

International Monetary Fund, 2001, "Code of Good Practices on Fiscal Transparency," (Washington: International Monetary Fund).

International Monetary Fund, 2001, "Government Finance Statistics Manual," (Washington:

[48] Mainly amounts of debts owed to multilateral and bilateral organizations.

International Monetary Fund).

International Monetary Fund, 2001, "Manual on Fiscal Transparency," (Washington: International Monetary Fund).

Lienert, Ian, 2003, "A Comparison between Two Public Expenditure Management Systems in Africa," IMF Working Paper WP/03/2, (Washington: International Monetary Fund).

Potter and Diamond, 1999, "Guidelines for Public Expenditure Management," (Washington: International Monetary Fund).

3. Ministry of Foreign Affairs website (Japan)

On the Ministry of Foreign Affairs ODA website (http://www.mofa.go.jp/mofaj/gaiko/oda/index.html) information of international trends regarding the HIPC initiative and PRS processes, and summaries and proceedings of discussions on HIPC initiative and PRS process at international conferences on MDGs, DAC of OECD, and other occasions can be obtained.

4. JICA website

The following reports can be obtained from JICA Report and Audio Visual website (http://www.jica.go.jp/activities/reportvideo/index.html):

JICA (2001) "*Hinkon sakugen ni kansuru kisokenkyu*"

JICA (2003) "*Enjo no choryu ga wakaru hon*"

JICA (2003) "*Tojokoku ni okeru zaiseikanri to enjo -- Aratana enjo no choryu to tojokoku no kaikaku*"

JICA (2003) "*Shokuryo zosan enjo (2KR) jissi keikaku shuho ni kakaru kisokenkyu hokokusho*"

JICA (2004) "*Kokusai kyoryoku kiko nenpo*"

JICA (2004) "*PRSP process jirei kenkyu -- Tanzania, Ghana, Vietnam, Cambodia no keikenkara*"

5. Ministry of Finance and the Board of Audit of Japan websites

On the Ministry of Finance's budget website (http://www.mof.go.jp/jouhou/syukei/syukei.htm) budget documents, documents of settlement of accounts, budget related documents, and budget speeches can be viewed. Budget and settlement of accounts documents since fiscal year 1947 are disclosed on the website. For example, the entire set of fiscal year 2004 budget documents (6 volumes with total purchase price of 12,720 yen at bookstore) can be downloaded from the site.

On the Board of Audit of Japan website (http://report.jbaudit.go.jp/org/houkoku-mokuji-list.htm) audit reports since 1947 are disclosed. In 2005, the audit report for fiscal year 2003 has already been presented. In the audit report, settled accounts, and fraud and illegal practices are reported together with reports on follow-up measures and their implementation.

6. Other websites

Other informative websites contributed to the compilation of this handbook are introduced below.

Asian Development Banks website (http://www.adb.org/Publications/default.asp). On this website the following two materials were obtained. The first is used as a textbook in PFM training courses organized by the World Bank.

Schiavo-Campo, Salvatore, Daniel Tommasi, 1999, "Managing Government Expenditure," (Manila: Asian Development Bank).

Schiavo-Campo, Salvatore, Daniel Tommasi, 1999, "Corruption and Public Financial management," (Manila: Asian Development Bank).

DFID publication website (http://www.dfid.gov.uk/pubs/). On this website there are a number of governance related publications. The following publications were referred to in this handbook:

Department for International Development, 2001, "Understanding and Reforming Public Expenditure Management," (London: Department for International Development).

Overseas Development Institute (ODI) publication website (http://www.odi.org.uk/publications/index.html). ODI is a non-profit private think thank based in UK. DFID and other international institutions have commissioned a number of studies on general budget support and aid coordination. On the website the following recent publications can be obtained:

Driscoll, Ruth, Karin Christiansen, David Booth, 2005, "Progress reviews and performance assessment in poverty-reduction strategies and budget support: A survey of current thinking and practice," (London: Overseas Development Institute).

National Graduate Institute for Policy Studies (GRIPS) website (http://www.grips.ac.jp/index-j.html). On this website research papers on the issues of PRSP and PFM can be obtained.

Transparency International publication website (http://www.transparency.org/knowl_intro.html). On this website publications and information concerning governance can be obtained. Global Corruption Report is one of the well-known reports which can be accessed here.

7. Japanese references

There are many Japanese references treating different aspects of PFM. Some are theoretical and comparative studies of Japanese and other country's PFM systems, an introductory book with explanation-oriented approach, and a book written by a government practitioner focusing on applications of PFM principles. The following references were used to compare Japanese and developing countries' PFM systems.

Campbell, John C. (1977) "*Yosan bundori -- Nihongata yosan seiji no kenkyu*."

Eguchi (2000) "*SRIC Report 2000.3 Vol.5 No.2 New Public Management ni yoru chihojichitai no management kaikaku eno shiten*."

Higo, Kazuo (1993) "*Zaiseigaku yoron dai 4 han*."

Hikime (2002) "*Zaisei kiritsu to chuoginko no balance sheet*."

IMF (2003) "*HIPC ni taisuru intiative (fact sheet)*."

International Development Center of Japan (2005) "*Sector Program nyumon*."

International Development Journal (1998) "*Kokusai kyoryoku yogoshu*."

JBIC Institute (2004) "*Taigai seisaku to shiteno kaihatu enjo*."

Jinno, Naohiko (2002) "*Zaiseigaku*."

Katayama (1999) "*Zukai kokkayosan no shikumi*"

Kokusai kinyu joho center (2002) "*IMF/World Bank no DSA wo meguru bunseki*."

Kwakita, Chikara (2004) "*Heisei 16 nendo zusetsu nihon no zaisei*."

Ministry of Finance (2004) "*Heisei 16 nendo ippankaikei yosan (heisei 16 nendo ippankaikei yosan sanshosho tenpu dai 159 kai kokkai (joukai) teishutu*."

Ministry of Finance (2004) "*Heisei 16 nendo seifukankei kikan yosan dai 159 kai kokkai (jokai) teishutu*."

Ministry of Finance (2004) "*Heisei 16 nendo tokubetu kaikei yosan (heisei 16 nendo tokubetu kaikei yosan sanshosho tenpu dai 159 kai kokkai (jokai) teishutu*."

Ministry of Finance (2004) "*Heisei 16 nendo yosan oyobi zaisei toyushi keikaku no setsumei dai 159 kai kokkai (miteiko)*."

Ministry of Finance (2004) "*Heisei 16 nendo zeisei kaisei no youko sozei oyobi inshi shunyuyosan no setsumei (dai 159 kai kokkai)*."

Ministry of Finance (2004) "*Zaiseiho dai 28 jo niyoru heisei16nendo yosan sanko shorui dai 159 kokkai (jokai) teishutu*."

Miyawaki, Jun (1999) "*Zukai zaiseino shikumi*."

Nakao, Takehiko (2005) "*Wagakunino ODA to kokusaitekina enjo choryu -- Tokuni kokusai kinyu no shitenkara*."

National Graduate Institute for Policy Studies (2003) "*Vietnam ni okeru JBIC/World Bank/ADB niyoru enjo tetsuzuki no chowaka*."

National Graduate Institute for Policy Studies (2005) "*Enjo modality no sentaku to nihon no ODA kaikaku 2005*."

Oosumi, Soshiro (1999) "*New Public Management -- Rinen bijon senryaku*."

Sakano, Taichi, Aoki (2000) "*Kaihatu tojokoku to koukyo zaisei kanri*."

Takahashi, Makoto, Shibata, Tokue (1988) "*Zaisei gaku dai 3 han*."

World Bank (2005) "*Sekai ginko nenji hokokusho*."