Effective Financial Scrutiny:
The Role of Parliament in Public Finance

Prepared by
Joachim Wehner
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**Introduction and overview**

Budgets affect all of us. Businesses analyze budget policy in order to make investment decisions that impact on growth and employment. As citizens, we depend on the state to provide crucial services and infrastructure. Whether new roads will be built, whether our children will have schools to go to or whether clinics can adequately cater for the health care needs of the population depends, to a large extent, on the way government raises revenues and allocates money to meet various competing and sometimes conflicting needs.

The budget is the most important economic policy tool of a government and provides a comprehensive statement of the priorities of a nation. As the representative institutions of the people, national legislatures are the appropriate place to ensure that the budget optimally matches a nation’s needs with available resources. Effective legislative participation in the budget process establishes checks and balances that are crucial for transparent and accountable government and ensuring efficient delivery of public services.

Governments are large and complex institutions, and this is reflected in their budgets. Measured in terms of revenues and numbers of employees, some national governments are among the biggest organizations in the world. This makes budgeting in the public sector inherently complex. Budget documents can comprise thousands of pages, the format of the budget is not always easily understandable, and thorough analysis can take a lot of time. Budget scrutiny can be a daunting challenge facing legislators when they are asked to consider the annual revenue and expenditure proposals of the government.

From a long-term perspective, the influence of national legislatures on budget policy has declined in many industrialized countries. It now appears, however, that many legislatures are rethinking their role in the budget process and reasserting themselves as more active players. The purpose of this training module is to make a contribution towards supporting parliamentarians and parliamentary staff to effectively participate in the budget process.

The module contains the following units:
- **The evolution of parliament's power of the purse:** Parliaments have struggled for a role in the budget process. This unit gives an overview of the history of parliamentary involvement in public finance. Much of this module focuses on the development of the House of Commons, which was at the forefront of claiming the ‘power of the purse’, but other countries are also considered.

- **Introducing the budget:** The second unit is a basic introduction to the budget and some related concepts that frequently feature in discussions on budgeting. It looks at the definition of the budget and its components, including revenues, expenditures and the deficit, as well as some of the key objectives of budgeting.

- **The budget process:** The budget cycle in government typically involves a number of different actors and follows a sequence of essential steps. This unit introduces some of the main participants of the budget process and presents a simplified and generalized outline of planning, approving, implementing and auditing expenditures.

- **Parliamentary approval of the budget:** One or perhaps the main task of parliaments in budgeting is to review the draft budget tabled by the executive for the upcoming fiscal period. This unit provides an overview of some of the key issues that make for effective scrutiny of the executive draft budget including parliament’s constitutional powers, its committees, the timing of the budget process, and access to relevant information.

- **Parliament and the audit of public accounts:** Many parliaments not only approve the budget, but also assess the integrity of budget execution through involvement in the audit process. This unit looks at different approaches to parliamentary audit. It covers the types of supreme audit institutions and the types of audits they conduct, the interaction of auditors with parliament, the role of parliamentary committees, and, finally, the use of follow-up mechanisms to ensure that governments implement recommendations for improvements that are generated through the audit process.

- **Opening up the parliamentary process:** Many parliaments are considering whether to open up the parliamentary budget process to the media and the public, or whether they could more directly benefit from outside expertise for the scrutiny of
government finance. This unit looks at the pros and cons of opening up committees to the public and how a committee can organize public hearings on the budget.

- **Strengthening parliamentary involvement**: To conclude this module the final unit offers a short diagnostic framework that can be used to assess the effectiveness of legislative financial scrutiny in particular countries.

Throughout the text, core concepts are highlighted and explained. Short definitions of all highlighted concepts are included in a separate appendix that contains a glossary of terminology related to the budget. Each unit concludes with suggested questions for discussion as well as a list of relevant internet resources and a select bibliography.
Unit 1: The evolution of parliament’s power of the purse

Learning Objectives
What is Parliament’s role in budgeting?

After studying this unit, you should be able to:

- Explain why parliaments came to have a role in budgeting
- Understand the importance of legislative oversight
- Describe some of the methods and institutions parliaments devised in order to exercise control over public finances
- Discuss constraints on parliaments in scrutinizing public finances

Introduction

The finance of the country is ultimately associated with the liberties of the country... If the House of Commons by any possibility lose the power of the control of the grants of public money, depend upon it, your very liberty will be worth very little in comparison. That powerful leverage has been what is commonly known as the power of the purse - the control of the House of Commons over public expenditure.

William Ewart Gladstone, 1891

How did parliaments come to exercise the budgetary roles they have today? Why do they participate in the budget process in the first place? To answer these questions, and as a background to the subsequent units, this unit provides a brief overview of some key stages in the evolution of the role of parliament in budgeting. The following sections look at the struggle to ensure parliamentary consent to taxation, how the rise of modern budgeting helped parliament to control expenditures, and more recent developments relating to the role of legislatures in budgeting.
The struggle for parliamentary control of taxation

The struggle to ensure consent to taxation was a central battlefield in the evolution of parliament in medieval England. To guard against despotic royal rule, parliament sought to limit the kings’ powers to impose taxes so as to curtail their ability to maintain a standing army beyond times of war and immediate external threat (Harriss 1975). The principle of parliamentary consent to taxation gained constitutional recognition when it was enshrined in the Magna Carta – a list of concessions to the barons that King John signed at Runnymede in 1215. But this agreement did not resolve the conflict over the power to impose taxes, which continued to simmer throughout the following centuries.

Bitter contests between kings and parliaments in the seventeenth century precipitated procedural innovations that advanced parliamentary control of state finance. In particular parliament’s increasing use of a committee of the whole House brought several advantages, due to the fact that the procedures of committees applied for such deliberations, rather than the standard rules. This allowed the Commons to appoint their own chairperson, which reduced the influence of the Speaker, who at the time was generally regarded as aligned with the monarch. The committee procedure also allowed each member to speak more than once and thus facilitated much freer debate. It became easier for the Commons to delay passing the bill to grant subsidies to the crown until the end of a session, a tactic that afforded time to extract concessions from the monarch. But clever procedural devices were not enough to establish parliamentary supremacy over taxation.

A crucial shortcoming of parliamentary control was that it did not extend to royal borrowing on the monarch’s personal credit. After Charles II claimed the throne in 1660 parliament started to demand estimations of cost before voting money to be granted to the king, who claimed to get short shrift. To evade expenditure control, a popular royal tactic was to resort to borrowing and hope that parliament would later consent to the raising of funds to repay such loans. But this practice was not sustainable when parliament refused to oblige. In 1672 the government in effect declared the only state bankruptcy in British history when payments on loans from City bankers were suspended initially for twelve months, which was later renewed repeatedly. Only after 1688 was
executive borrowing tied to parliamentary consent, which restored trust with lenders and ensured large-scale access to finance over the following centuries.

The Glorious Revolution of 1688 brought a decisive victory for parliament, and it is a landmark in the evolution of its financial role. The 1689 Bill of Rights captures the outcome of the struggle. Most importantly, it firmly established the principle that only parliament could authorize taxation by proclaiming ‘That levying money for or to the use of the Crown by pretence of prerogative, without grant of Parliament, for longer time, or in other manner than the same is or shall be granted, is illegal.’ Still, at this stage there was still no such thing as an annual budget, and there was no comprehensive control of expenditures.

Before the revolution the royals freely mingled public and private income. Following the revolution parliament made a life-long grant to the king to cover expenditures on the civil list and the monarch in turn relinquished control over most of his hereditary revenues. Originally, the list was intended to cover the financial requirements of the king and his household as well as the expenditure of the central civil government excluding debt charges. Expenditure items for civil administration were gradually transferred from the list to the supply services and, later, the consolidated fund, in a process that lasted until 1830. The creation of this list was the first step towards the separation of public and royal expenditures.

Paradoxically, in these early days of growing financial control by the Commons one can also find the origin of limitations on parliament’s budgetary powers. Given the political dynamics of the time, it made little sense for parliament to volunteer money to the crown. The Commons proceeded to resolve in 1706 ‘That this House will receive no Petition for any sum of Money relating to public Service, but what is recommended from the Crown.’ The financial initiative of the crown has been enshrined in the standing orders since 1713 and this limitation on parliament’s power of the purse is considered an essential constitutional principle to this day. Therefore, while the British Parliament was at the forefront of claiming budgetary rights, it was also the first parliament to voluntarily restrict its powers to introduce and amend financial legislation (Inter-Parliamentary Union 1986, p. 1093):
Parliament still respects this long-standing custom and practice and, as a result, it may not vote sums in excess of the Government’s estimates. Consequently, the only amendments that are in order are those which aim to reduce the sums requested and have as their purpose the chance for Members to raise explanations before the sums in question are approved.

After the Glorious Revolution, it was not long before parliamentary control over taxation spread beyond Britain. Parliament proved to have a short memory for the passions that could be incited by unilateral imposition of fiscal measures. As imperial finances were exceedingly stretched by the task of protecting vast colonial territories, parliament sought to force the inhabitants of the empire’s North American possessions to contribute towards the defense of the territory. In 1765 it ordered the imposition of a tax on a stamp affixed to a range of documents including newspapers and playing cards. This gave rise to great discontent in the colonies, and led to a boycott of British goods by the colonialists. Despite a partial retreat by parliament, which abolished the ‘stamp tax’ and several other duties, the continued imposition of a duty on tea was sufficient to provoke unrest and ultimately led to the war of independence. At the First Continental Congress in 1774 delegates from the colonies rejected ‘every idea of taxation, internal or external, for raising a revenue on the subjects in America, without their consent.’

**The rise of modern budgeting**

Parliamentary control remained incomplete as long as governments continued to enjoy wide discretion in expending public revenues. Without detailed knowledge of expenditure needs, requests for funds could not be properly evaluated. Following the Glorious Revolution, it took the Commons two further centuries to put in place a comprehensive system of expenditure control. There were some interim achievements, notably the creation of the consolidated fund in 1787. But the development of modern budgeting practices in the United Kingdom had to wait until the Gladstonian reforms in the second half of the nineteenth century.

By the beginning of the nineteenth century, the United States Congress already constrained executive discretion through detailed line item appropriations that prescribed
the exact use of authorized expenditures, for instance by setting strict limits on specific expenses such as firewood and candles in particular offices. This tradition has its origins in colonial times, when legislatures were distrustful of British rule and invested much effort in scrutinizing administrative expenditures. The colonialists were suspicious of governors they did not appoint and who were regarded as agents of the king in distant Britain. They thus devised stringent and humiliating control mechanisms including the annual voting of salaries, detailed specification of the object of spending and the amount to be spent, and the reversion of unspent funds to the treasury at the end of the fiscal period. This advanced level of congressional scrutiny of expenditures was exceptional compared with other countries at the time.

In Europe, France was first in developing modern expenditure control mechanisms based on reforms of state audit during the first half of the nineteenth century. Napoleon put in place the institutional fundamentals of modern public audit when he created the cour des comptes in 1807. In the initial years following the creation of the court the benefits of the new audit system for the French National Assembly were marginal. To ensure effective reporting to the assembly, the publication and distribution of audit reports was made a legal requirement in 1832. The assembly also gradually broadened its control over the approval of expenditures until the specification of detailed items of expenditure for each ministry became a legal requirement in 1831. By the middle of the nineteenth century, France had put in place many of the elements that are associated with modern budgeting, notably a comprehensive budget encompassing all of the activities of government, a standard fiscal year, the principle of annual authorization, and a developed system of accounting and audit control.

Control of expenditures evolved differently in the United Kingdom. Parliament appropriated money many centuries before the use of budgets became common. A first known instance of parliamentary appropriation dates back to the fourteenth century, when a grant to the Edward III was explicitly earmarked for ‘the Maintenance and Safeguard of our said Realm of England, and on Wars in Scotland, France and Gascoign, and in no places elsewhere during the said Wars’ (Einzig 1959, p. 79). Particular sources of revenue were also frequently tied to specific expenses in order to exercise some control over royal spending. However, parliamentary oversight of expenditures remained patchy and incomplete. An important improvement was the creation of the consolidated
fund in 1787 for the purposes of collecting revenues and disbursing all monies for the supply of public services, which ‘broke the disorder caused by assigning particular taxes to special purposes and it provided the means of infinite expenditure control through comprehensive appropriation schedules’ (Reid 1966, p. 57). But full expenditure control had to wait until the rise of modern budgeting.

The decisive steps towards modernization of public finances in the United Kingdom are inextricably linked to William Ewart Gladstone, who first became Chancellor of the Exchequer in 1852. Gladstone was determined to force greater economy in public finance and introduced reforms in the 1860s that made annual and comprehensive estimates central to legislative oversight. In 1861 the Commons, based on the initiative of Gladstone, resolved to establish a public accounts committee to examine the accounts showing the appropriation of the sums granted by parliament for public expenditure. The Exchequer and Audit Departments Act of 1866 required all government departments to produce appropriation accounts for audit purposes. The act also created the comptroller and auditor general by merging the \textit{ex ante} function of authorizing the issue of money to departments with a new \textit{ex post} function of examining every appropriation account and reporting the results to parliament. The committee developed a high standard of scrutiny and contributed significantly to rapid improvements in the disclosure of financial information in the following decades (Chubb 1952).

In the United Kingdom a final step towards the democratization of the budget was taken when the hereditary chamber, the House of Lords, was stripped of its veto power over financial legislation. The elected House of Commons considered the Lords unable to amend tax and spending bills by the end of the seventeenth century. The formal removal of remaining veto power was triggered by the dramatic struggle over the 1909 budget of Chancellor Lloyd George, who sought increased tax revenues in order to pay for pensions and defense expenditures (Porritt 1910). When the Lords rejected the entire Finance Bill, this prompted the passing of the Parliament Act of 1911, the purpose of which was to debar the Lords from rejecting \textit{money bills} – legislation strictly related to taxation, borrowing or appropriations. Since then, the supremacy of the elected chamber has been firmly established. Budgetary bicameralism of various forms continues in countries where second chambers of parliament have democratic credentials.
More recent developments in legislative budgeting

Parliamentary fiscal power in the United Kingdom was at its peak in the second half of the nineteenth century, when the Commons frequently amended spending and revenue proposals (Einzig 1959). The spread of parliamentary democracy since the nineteenth century ensured that the principle of parliamentary authorization of taxation and public expenditure became a constitutional fundamental across democratic countries. However, from a long term perspective the influence of national legislatures on budget policy making has declined in most industrialized countries (Coombes 1976). The budgetary decline of parliament is perhaps most evident in the United Kingdom, where the House of Commons ceased to amend estimates almost a century ago.

Several developments contributed to reducing the budgetary activism of parliaments (Schick 2002). The emergence of disciplined political parties has reigned in legislative independence. Devolution of spending, and to a lesser extent of revenues, has chipped away at the comprehensive control of public funds by national legislatures. In addition, the massive expansion of entitlement spend in the twentieth century has substantially rigidified budgets and commensurately decreased the remaining margin for active legislative engagement in annual budgets. With the growth of public spending and the increasing complexity of public finances, the executive budget proposal became the standard against which legislative action was measured.

But the decline of parliamentary power over budgets is not universal. There are signs that some parliaments are attempting a budgetary comeback. In France, for instance, the National Assembly recently initiated a wide-ranging set of budget reforms. The resulting changes include a reclassification of the budget in order to support parliamentary oversight and an expansion of powers to amend expenditures (Chabert 2001). In developing and transition countries, a substantial number of legislatures are moving towards budgetary activism. Perhaps the primary reason for this development is that democratization and constitutional change have opened up possibilities for legislature participation in many previously closed systems. A good example is the Brazilian Congress, which historically played no significant role in the budget process. Democratization in the 1980s led to constitutional changes that gave Congress powers to modify the budget and have resulted in substantial levels of activism (Blöndal et al 2003).
In addition, there has been a recent shift in international financial institutions and donor agencies towards participation in setting development goals and strategies. Developing countries are now asked to access international finance on the basis of comprehensive poverty reduction strategies that are meant to be compiled through an in-country participative process. This shift is linked to renewed interest by the international donor community in the quality of the budget process and the governance of the budget for a variety of reasons, in particular the realization of the failure of conditionality in development lending and evidence on the effectiveness of aid. This provides an opportunity for legislatures in poor countries to reengage with development policy and budgets (Stapenhurst and Pelizzo 2001).

Conclusion

The budgetary role of democratic legislatures is the outcome of a centuries-long struggle for supremacy in public finance. Historically, parliaments first gained the right to consent to taxation, and gradually they devised mechanisms to control the expenditure of public funds. Modern budgets came to aid comprehensive legislative oversight. Legislatures today exercise varying levels of budgetary influence. While some parliaments have become less active in budgetary matters, others have maintained a strong role in the budgeting process. Democratization and constitutional reform provide opportunities for new parliaments to actively define an appropriate budgetary role.

Unit 1 Questions

Please answer each of the following questions. If you are taking this course in a group you may then meet to discuss your answers.

- Why did Gladstone say that ‘the finance of the country is ultimately associated with the liberties of the country’?
- Taking your country as an example, how would you describe the development of legislative financial scrutiny over time? What factors have influenced this evolution?

Relevant internet resources
Bill of Rights (1689)
http://www.yale.edu/lawweb/avalon/england.htm

British Broadcasting Corporation:
A to Z of Parliament
http://news.bbc.co.uk/1/hi/uk_politics/a-z_of_parliament/default.stm

California Department of Finance:
Development of Modern Budgeting
http://www.dof.ca.gov/fisa/bag/history.htm

Magna Carta (1215)
http://www.bl.uk/collections/treasures/magna.html

Select bibliography


Unit 2: Introducing the budget

Learning objectives
What are the components of the Budget?

After studying this unit you should be able to:

- Define the budget and its components
- Discuss possible effects of high deficits
- Understand the principles of good budgeting
- Explain the three objectives of public expenditure management

Introduction

In the most general definition, budgeting is concerned with the translation of financial resources into human purposes.

Aaron Wildavsky, 1984

What is a budget and what purpose does it serve? This unit introduces the budget and some related core concepts and terminology. The following sections consider the definition and components of the budget, and the objectives of budgeting as proposed by current public expenditure management theory.

Definition and components of the budget

The word budget developed from *bougette* or ‘small bag’ in middle French. The use of the word spread to England, where it came to designate the leather bag in which ministers of the crown carried financial plans to parliament, and eventually it became synonymous with its contents. The use of the word in the United Kingdom now refers to the spring financial statement, which focuses on taxation measures. In most countries, the term refers to the annual expenditure and revenue plans tabled in the legislature. The first traceable legal definition of the budget is contained in a French decree of 1862: ‘The budget is a document which forecasts and authorizes the annual receipts and expenditures of the State...’ (Stourm 1917, p. 2). In most countries, the government
budget is drafted at regular intervals by the executive and tabled in the legislature for review and approval before the beginning of the fiscal year to which it applies.

**Box 1: Origins of the fiscal year**

In early budgeting, there was a clear link to the crop cycle. Once the harvest was in, one could make plans for the next year. Many developing countries have maintained this connection by clinging to the broken budget year. In India, the revenue for the subsequent year can only be assessed after the Monsoon season in May, June and July. But agriculture is not the only source of income to be taken into account in the Third World. Papua New Guinea changed its budget year to fit that of the donor countries, since their contributions were so decisive for the government’s economic planning. In other parts of Asia, governments hesitate between the lunar and the solar calendars. Over time, there has been a tendency to converge on the calendar year as the most convenient basis for budgeting. While the United Kingdom has held out with a budget year beginning in April, Sweden gave up the broken budget year to adopt the calendar year model in 1995. In the long discussion preceding this decision, it was claimed that a harmonization both upwards (towards the European Union) and downwards (towards private enterprises, communes and regions which had long practiced calendar year budgeting) would bring about greater transparency and facilitate coordination between different levels.


Sources of income vary substantially between countries. They usually include direct taxes, which are levied on income or capital, for example income tax. Such taxes are called direct because it is normally assumed that the real burden of payment falls directly on the person or firm that is immediately responsible for paying them. By contrast, indirect taxes such as sales taxes or excise taxes on alcohol and tobacco are so called because it is assumed that the real burden of paying the tax will not fall on the firm immediately responsible for paying it but rather that it will be passed on to the customer. Other sources of government income might consist of user charges for certain services, foreign aid, and income from investments or commercial activities.

In considering its revenue raising options, the government has to weigh advantages and disadvantages. For example, boosting reliance on sales taxes makes taxation more regressive. This means that a poor person will pay as much tax as a rich person when purchasing an item of clothing or food, as sales tax does not take account of income differentials. On the other hand, income taxes are progressive when they apply higher rates to individuals with a higher level of income. But where the formal economy is small, excessive taxation of a few high income individuals can undercut investment, which hampers growth and employment creation. Over time, this might erode the tax base and reduce the ability of government to raise revenues. Raising an adequate amount of
revenues, while at the same time preserving equity and stimulating economic growth, can be a difficult balancing act.

On the expenditure side of the budget, government allocates funds to various functions such as health care, education, agriculture, justice, defense and so on. This is called the functional classification of expenditures. The share of total expenditures allocated to each sector is a key indicator of spending priorities for a given year and of shifts in priorities over a period of time. In terms of the economic classification of expenditures a distinction can be made between current and capital expenditures. Current expenditures are on goods and services that are consumed immediately, for example wages of civil servants or supplies of learning material for schools. Capital expenditures comprise money spent on the purchase of goods that can be used to produce other goods, for example machinery or infrastructure. The balance between current and capital spending is important. When a clinic is built and equipped to service a community (a capital expenditure), then government has to make sure that it sets aside sufficient funds to run the clinic on a day to day basis, which requires budgeting for wages, medicines and the like (current expenditures).

When government spends more money than the available revenues, it can either raise taxes or budget for a deficit and cover the shortfall with borrowed money. There is a wide range of alternate deficit measures, but the conventional deficit is widely quoted as perhaps the central indicator of fiscal health. This deficit measure is defined as the excess of government’s total expenditure over total revenue. There is no absolute figure that can indicate whether the deficit is too large, which depends on the size of the economy. For this reason, the deficit to Gross Domestic Product (GDP) ratio is used to indicate the share of national income that will have to be used to finance the deficit. Although the appropriate size of the deficit depends on a variety of factors that determine sustainability on a case by case basis, one rough but widely accepted benchmark was set in the European Union’s Maastricht Treaty with a figure of three per cent of GDP. However, some go further and demand balanced budgets where revenues are equal to expenditures. Changes in the deficit do not have to be the result of a shift in fiscal policy, but can also reflect the business cycle, for instance. Consistently growing deficits, however, give cause for concern:
- Government borrowing can put upward pressure on interest rates so as to ‘crowd out’ private sector investment. In other words, when government uses most of the capital available on the borrowing market, less is available for the private sector to borrow in order to expand its activities. This can dampen economic growth.

- Deficit spending is expensive. Because government will have to put aside a proportion of funds to service its stock of debt, there will be less money for service delivery. Reductions in service delivery programs affect vulnerable groups in society that are most dependent on the state.

- It is unfair if extensive borrowing forces future generations to make sacrifices so that they effectively pay for spending that we enjoy today. This problem is exacerbated when borrowed funds are not invested productively.

- Excessive deficits are associated with inflation. Some governments have resorted to ‘printing money’ in order to meet debt servicing obligations. However, this strategy is difficult to pursue when the central bank enjoys entrenched independence from the government both legally and in practice.

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**Box 2: Principles of good budgeting**

**Comprehensiveness:** The budget must cover all the fiscal operations of government, encompassing all public expenditure and revenues, to enable full and informed debate of the tradeoffs between different policy options.

**Predictability:** Spending agencies should have certainty about their allocations in the medium term to enable them to plan ahead. Stable funding flows support departmental planning and efficient and effective delivery.

**Contestability:** No item in the budget should have an automatic claim to funding. All policy and attached funding should be regularly reviewed and evaluated in order to ensure prioritization and optimal performance of spending agencies.

**Transparency:** All relevant information required for sound budgetary decision making should be available in an accessible format, and in a timely and systematic fashion. Budget information needs to be accurate, reliable and comprehensive.

**Periodicity:** The budget should cover a fixed period of time, typically one year, and the process of compiling the budget should follow a clear and reliable schedule that is agreed upon and published in advance.

Objectives of budgeting

If resources were limitless, we could all get whatever we want from the government. There would be no need to budget. In reality, spending needs are inevitably beyond available funding. Governments have to make choices about the allocation of scarce resources to meet competing needs in society. Budgeting is effective in facilitating this process when it forces awareness of overall fiscal constraints, enables the prioritization of spending in line with policy objectives, and supports the efficient implementation of policies.

<table>
<thead>
<tr>
<th>Objective</th>
<th>Requirements</th>
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<tr>
<td><strong>Aggregate fiscal discipline</strong></td>
<td>Budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. These totals should be set before individual spending decisions are made, and should be sustainable over the medium term and beyond.</td>
</tr>
<tr>
<td><strong>Allocative efficiency</strong></td>
<td>Expenditures should be based on government priorities and on effectiveness of public programs. The budget system should spur reallocation from lesser to higher priorities and from less to more effective programs.</td>
</tr>
<tr>
<td><strong>Operational efficiency</strong></td>
<td>Agencies should produce goods and services at a cost that achieves ongoing efficiency gains and (to the extent appropriate) is competitive with market prices.</td>
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Aggregate fiscal discipline refers to the control of the key measures of fiscal performance, including total spending, total revenue, the financial balance and the public debt. Fiscal discipline requires that budget totals are the result of explicit and enforced decisions. Many factors are important for determining the appropriate total level of aggregate spending, including available revenues, access to borrowing and the acceptable level of the deficit. Given these constraints, fiscal discipline calls for affordability of total spending, including in the medium to long term. Some countries have adopted formal rules to ensure fiscal discipline, for example by allowing borrowing for capital purposes only (the so-called ‘golden rule’). A strong treasury or finance ministry can check that spending departments do not make exaggerated claims on the budget and that they stick to their budgets once they have been approved. A hard budget constraint on departmental spending exists when the treasury is successful in enforcing approved budgets. This requires comprehensive and reliable information to monitor compliance of government departments with spending plans. To safeguard fiscal discipline, parliament has to resist
the temptation to add new spending without commensurate cutbacks elsewhere in the budget.

Because resources are limited, budgeting forces us to consider the merit of competing claims on the public purse and to negotiate tradeoffs between them. The achievement of allocative efficiency or strategic prioritization requires government capacity to allocate resources and select programs and projects in conformity with its objectives. This process is supported where the policy basis of the budget is stated clearly on the basis of a medium term strategy. Allocative efficiency is threatened where spending departments are bailed out when they overspend, because poor budget execution can introduce substantial ad hoc realignments that distort stated priorities. Such distortions often divert resources away from the poorest and most vulnerable groups in society to cater for the interests of bureaucracies and strong interest groups. Parliament can provide an important platform for public debate on the nation’s priorities.

Once funds have been allocated they should be spent so as to deliver maximum results. Operational efficiency is the ratio of the resources expended by government agencies to the outputs produced or purchased by them. Spending departments should strive to eliminate waste and produce goods and services at a cost that achieves ongoing efficiency gains. To provide managerial incentives for operational efficiency high level civil servants can be given performance contracts that spell out clear objectives and targets. Moreover, effective parliamentary scrutiny and accountability for results can support a mind shift in spending departments from a mentality of compliance to one of achievement. Parliaments increasingly consider not only the allocation of money, but also what is delivered with that money. To facilitate legislative review of departmental performance the format of the budget needs to go beyond the traditional focus on cost and inputs. Also needed is information on strategic objectives, output targets (the amounts of goods and services to be delivered) and outcomes (the effects or impact of the activities carried out on the community). Parliamentary scrutiny of audit findings also strengthens accountability for performance.
Box 3: Budgeting for performance

Performance budgeting has been a prominent theme in budget reform for several decades. Such efforts have taken many forms, and success varies. One reason is that the idea of performance budgeting is appealingly simple, but very difficult to implement in practice. A broad definition of a performance budget is one where the budget presents information on what departments have done or expect to do with the money provided to them. Many countries are now providing such information as part of their budget documentation. More strictly defined, a performance budget is only a budget that explicitly links each increment in resources to an increment in outputs or other results. There are very few successful examples of performance budgeting in the stricter sense, and New Zealand is arguably the country that has taken this approach furthest.


The objectives of aggregate fiscal discipline, allocative efficiency and operational efficiency are interrelated. In many ways fiscal discipline comes first. For example, politicians often promise improving macroeconomic conditions such as higher growth, less unemployment and lower inflation, all of which impact on the amount of revenues government expects to collect. Overly optimistic revenue forecasts are politically tempting because they create an imaginary space for promises of more money on services. The inevitable revenue ‘shortfalls’ result in higher deficits or necessitate expenditure cuts that distort spending priorities so that allocative efficiency is undermined. In-year spending cuts also undermine predictability, which is an important prerequisite for operational efficiency in departments. To be transparent government should publish the macroeconomic assumptions and projections upon which the budget is predicated. It is a good test of government’s budgetary foundation to consider whether its growth forecasts are substantially more optimistic than those produced by the private sector and international organizations. If this is the case, it is rather likely that the budget is unsound. Unrealistic assumptions about improvements in revenue collection are another symptom of escapist fiscal planning. Such tactics threaten to undermine the objectives of budgeting.

Box 4: A note on fiscal decentralization

Decentralization of central functions to lower level government units has become an important element of public sector reform in recent years. It is hoped that decentralization can promote local innovation, match services with local preferences, and that greater accountability to local communities can achieve more efficient provision of essential services where central government has not been able to deliver. However, in the initial stages of decentralization, there are often capacity bottlenecks at the subnational level. For this reason, fiscal decentralization should be complemented with adequate oversight and accountability mechanisms to ensure that the process of decentralization is managed optimally and to guarantee equitable access to services. For instance, the legislature should have access to detailed spending information across levels of government, and it should scrutinize the underpinning revenue sharing arrangements.
Conclusion

Budgets are regularly produced financial plans of the government comprising revenues and expenditures of the state. They should be comprehensive and transparent and ensure funding predictability for government departments. Public resources are always limited and inevitably fall short of meeting all the needs of society. For this reason the budget process is used to assess competing claims on the budget and to facilitate difficult tradeoffs. Meeting this challenge successfully requires that budgeting achieves and maintains fiscal discipline, the strategic prioritization of public funds, as well as sound operational management.

Unit 2 Questions

Please answer each of the following questions. If you are taking this course in a group you may then meet to discuss your answers.

- Does it matter if governments have high budget deficits?
- List some of the main sources of government revenue. Which of these are important in your country?
- How does the budget in your country compare to the principles of good budgeting?
- Are fiscal discipline, allocative efficiency and operational efficiency the only objectives of budgeting?

Relevant internet resources

American Association for Budget and Program Analysis:
http://www.aabpa.org/

Governance Resource Centre Exchange:
Public Financial Management and Accountability
http://www.grc-exchange.org/g_themes/pfma.html

International Monetary Fund:
Guidelines for Public Expenditure Management

Overseas Development Institute:
Centre for Aid and Public Expenditure
http://www.odi.org.uk/pppg/cape/
Select bibliography


References


http://www1.worldbank.org/publicsector/pe/english.htm