Models of Public Budgeting and Accounting Reform

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

The papers in this supplement to the *OECD Journal on Budgeting* originated from an international symposium held in April 2001 in Beijing, China. The symposium was sponsored by the Ministry of Finance of the People's Republic of China and was conducted by the National Institute of Accounting, in association with Tsinghua University's School of Economics and Management and Institute of Accounting Research.

The papers give a comprehensive overview of various OECD Member country accounting models and as such are valuable not only to China, but to all countries. The main theme of these models is accountability and confidence in the execution of the budget plan. While the models are different and constructed to meet the needs of individual countries, there is great utility in presenting a comparative understanding of the theoretical basis for the systems. This understanding is especially important for non-member countries where an OECD "best practices" approach may not be valid. Presentations like these show that there is no single way to construct an accounting system, but rather that principles and common elements are important.

The views expressed are those of the authors and do not commit or necessarily reflect those of governments of OECD Member countries.

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MODELS OF PUBLIC BUDGETING AND ACCOUNTING REFORM

James L. Chan, Editor
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PREFACE
BY
XIANG HUAICHENG*

China's financial systems have undergone essential changes since China adopted the reform and opening policy. The previous phase focused on fiscal revenues aspects, and the management of expenditures is emphasised in the present phase. The reforms of the fundamental management systems − such as government budgeting, treasury management system and budget accounting system − are particularly emphasised. This is a profound reform – indeed a revolution – of the traditional budget management systems. It covers changes in budget concepts, the budget preparation system and budgetary management. We hope that through this budget reform, we can promote the establishment of a public finance system that corresponds to the socialist market economy. Such a system would make better use of information technology and significantly improve the level of budget management. For this purpose, the Ministry of Finance of China has set up a special budget reform group. A number of capable and talented staff members will concentrate their time and energy on researching and solving the problems that are likely to be confronted in the budget reform process.

As the reform and opening-up process progresses further, continuous efforts will be made to improve and perfect China's enterprise accounting system and budget accounting system. In 1993, the enterprise accounting system underwent a fundamental reform. Enterprise accounting standards and the enterprise accounting systems by industry were defined and promulgated. This drew open the prologue of reform of China's enterprise financial accounting system. After that, 13 specific accounting standards were issued successively and a new enterprise accounting system was published by the end of 2000. This development occurred in the wake of the accelerated development of the China's capital market, the establishment and completion of a modern enterprise system and China's accession to the World Trade Organisation. These new standards and new systems, while exhibiting Chinese characteristics, are compatible fully with international accounting practices.

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In 1997, China's budget accounting system underwent fundamental reforms as well. These included: a new general budget accounting system, an administrative unit accounting system and the public service unit accounting system. The adoption of these systems signified the shift of China's budget accounting system to fit the socialist market economy. For the time being, combined with the reforming of budget management system, accounting systems for the government and non-profit organisations are studied and issued that both correspond with China's conditions and are in full co-ordination with the international accounting practice.

The Ministry of Finance has a tentative plan for the issue of government budgeting management and accounting reform in China. Vice Minister Lou Jiwei will address this topic during his presentation.

I note that all the experts present at the symposium have carefully prepared thoughtful papers of a high calibre. I believe their insightful presentations will certainly benefit all the participants. I extend my best wishes for a successful symposium.

INTRODUCTION BY JAMES L. CHAN*

The papers in this volume originated from an international symposium held in April 2001 in Beijing, China. The symposium was sponsored by the Ministry of Finance of the People's Republic of China and was conducted by the National Institute of Accounting, in association with Tsinghua University's School of Economics and Management and Institute of Accounting Research. As China engages intensively in reforming its government budgeting and accounting, there is a sense that developed nations may have valuable lessons to share. The symposium therefore sought to promote the exchange of knowledge and perspectives between Chinese policy-makers and scholars and their colleagues primarily in Europe and the United States.

China's current reform efforts are authoritatively described in considerable detail in this volume. These efforts have tried to incorporate the best practices from other – especially Western – nations. Rather than presuming to know what these practices are and who has them, I made an attempt to present a relatively comprehensive and representative sampling of contemporary Western practices in the field of government budgeting and accounting. Essentially there seem to be two schools of thoughts or patterns of practice ("models"). The Anglo-American model is rooted in the English traditions and has its modern manifestations in Great Britain itself, the United States, New Zealand among others. The Continental European model appears to have two variants: the "Latin" version is practised in France, Italy and Spain, and perhaps elsewhere; and the "German" version in, for example, Germany. Switzerland, and perhaps the Netherlands. The identification of countries sounds tentative because practices – being pragmatic – value usefulness rather than ideal types. For the symposium, it was neither possible (due to resource constraints) nor necessity (as only illustrative practices were sought) to include all countries. In this regard, the Chinese host wisely suggested the inclusion of Central and Eastern countries, whose reform experiences might also be instructive.

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Emerging from the details of the countries is the common theme of government accountability. The Continental European model seems to believe that executive accountability to Parliament is necessary and sufficient. The Anglo-American model, on the other hand, stresses the accountability of government – including both the Executive and Parliament – to the public. Despite their differences in emphasis, these two types of accountability are not mutually exclusive. Hopefully both notions will resonate with the Chinese, who are searching for the proper role of government in their unique formulation – a socialist market economy.

I am most grateful to the authors for writing original papers for the symposium and for their patient co-operation in the editorial process. They may not agree with my characterisation or classification of their countries in the above "models". However, I am certain that they share my hope that our presentations at the symposium – and now in print – are informative to Chinese policy-makers and scholars as they ponder the applicability of Western experiences.

I thank Minister Xiang Huaicheng for hosting the symposium, and Vice-Minister Lou Jiwei for contributing a comprehensive report of China's own reform experience. Mr. Li Yong, Assistant Minister of Finance, skilfully moderated the proceedings, with the able assistance of the ministry's staff, particularly Dr. Liu Xiaoming. The symposium proposal, first made two years ago, received early and enthusiastic support from President Liang Yuneng of the National Accounting Institute (NAI). Vice President Chen Xiaoyue of the NAI secured the sponsorship and funding that made the event possible. The symposium was one of my activities as a Visiting Professor during the Spring of 2001 at Tsinghua University, which provided a stimulating teaching and research environment.

The symposium papers are published in both English and Chinese. I am grateful to the Organisation for Economic Co-operation and Development (OECD) for sponsoring their publication in the English language for the international audience. I especially thank: Alex Matheson for endorsing the publication proposal; Jón Blöndal, Editor of the *OECD Journal on Budgeting* for consenting to present the papers in a supplementary issue; Michael Ruffner, Marie Murphy and Jennifer Gardner, and the staff of the OECD Publication Services for shepherding the project through the publication process.

Readers interested in obtaining a copy of the papers in Chinese or in learning more about budgeting and financial management in China may write to me at jimchan@uic.edu, or at Department of Accounting (M/C 006), College of Business Administration, University of Illinois at Chicago, 601 South Morgan Street, Chicago, IL 60607-7123, U.S.A.

PUBLIC ACCOUNTABILITY AND GOVERNMENT FINANCIAL REPORTING
BY

TOM L. ALLEN*

Public accountability of government is demonstrated in part by accounting standards that require fair presentation and full disclosure. In the United States, many of these standards are developed by the Governmental Accounting Standards Board (GASB). I have the privilege of serving as Chairman of the GASB, and it is an honour to have the opportunity to share our experience with China and other countries that seek to improve their governments' accounting and financial reporting. I hasten to add that my views do not necessarily reflect those of all members of the GASB or the opinions of any other individuals or organisations in the United States. I also recognise that countries have significant differences in their political systems, government structures, and economic and social objectives that impact financial reporting. I am going to briefly describe the environment in the United States, before discussing the GASB's standards-setting process and some significant standards.

1. The American public sector environment

To understand the structure for setting accounting standards in the United States, one must have a basic appreciation of the history and structure of each type of American Government and the role they are expected to play in the lives of their citizens. The United States operates in a decentralised government model where most governmental services are delivered by local governments such as cities and counties. Law enforcement, fire protection, local street maintenance, public education, and many utility services such as water, sewers, electricity, etc., are provided by the 87 000 local governments. These local governments fall within the geographic boundaries of the 50 states that make up the United States of America.

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These states represented the earliest form of government as the lands that make up the present United States were colonised and settled by Europeans. After their independence and the establishment of the United States of America in the late 1700s, the original 13 “states” decided that there were certain functions such as national defence and the regulation of interstate commerce that could best be carried out by a centralised national government. In doing so, the states made it clear that all authority and dominion remained with each state unless that authority was specifically granted to the federal government. States also authorise the creation of, and exercise various levels of control over, the local governments within their boundaries.

The states provide services on a state-wide level such as maintenance of interstate highways, health and various welfare services, higher education, etc., and they collect taxes (such as sales and income taxes) that are used by state and local governments to finance government operation. Local governments collect much of the revenues they use to operate themselves through local property taxes, user fees, etc.

Although the federal government provides limited local services, it has an important voice in the type and quality of state and local government services that are provided. The reason is that some of the federal tax dollars flow back in the form of contracts and grants that specify how the money is used. Often the money is used to promote national social policy objectives, such as racial equality in opportunity.

Americans also tend to believe that the role of government, although important, should be limited and that government should not be involved in providing services that can effectively be provided by the private sector. Of course, this generalisation varies between political parties and is not necessarily held by those who rely on governmental services to a large extent. What almost all citizens agree on, however, is that the role of government should not extend into the private lives or the religious worship of its citizens. I also believe that if asked, most citizens would express frustration about not having the necessary information to evaluate the effectiveness, or assess the financial public accountability, of their governments at all levels.

In the United States, all governments are viewed as being established “by the people” and “for the people”. Citizens, taxpayers, and others interested in governmental operations believe they are entitled to have open access to government information. Even though the theory is open government, in practice there are obstacles. However, these limitations do not generally extend to financial information about the government. The role of the GASB, and its counterpart at the federal level, is to help citizens to get the information necessary to assess the financial public accountabilities of their governments.

2. Setting governmental accounting standards in the United States

In the United States, there are actually three different accounting standards-setting boards. The Financial Accounting Standards Board (FASB), created in 1973, sets the accounting standards for the private sector, which includes businesses and not-for-profit organisations. The Governmental Accounting Standards Board was created in 1984 and is responsible for setting accounting standards for state and local governments. And the Federal Accounting Standards Advisory Board, created in 1990, recommends accounting standards for the federal government.

Since the federal government lacks authority over state and local governments, and the 50 state governments have no authority outside their own jurisdictions, setting financial reporting standards that will be recognised and acceptable at all levels of government is clearly a very difficult task. However difficult, financial reporting standards specifically for governments are needed because all levels of government have concluded that they will not follow the FASB's standards. Before the GASB was established, governments had argued that the private-sector standards were not relevant in a government environment. Although that point can be debated, that decision was nevertheless clear. The GASB's new reporting model for state and local governments moves governmental reporting closer to that used by businesses in the United States. However, even with the new reporting model, some important differences in reporting emphasis remain. It is this difference that justifies the existence of the separate accounting standards for the public sector in the United States. I will therefore briefly describe the evolution of our governmental accounting standards-setting institutions.

2.1. Federal accounting standards

The federal government for years issued an annual report primarily on its cash position and flows. But it has been the slowest level of government to convert self-determined rules and regulations into generally accepted accounting principles for guiding its external financial reporting. In 1990, the Federal Accounting Standards Advisory Board (FASAB) was created by the three officials responsible for federal financial management – the Secretary of Treasury, the Director of the Office of Management and Budget, and the Comptroller General of the United States. Under their sponsorship, the board sets standards to help enforce the Chief Financial Officers Act of 1990, which required federal agencies to issue annual audited financial statements. The FASAB comprises of nine members; six work for different federal government agencies and three are public members. After the board concludes its deliberations, a standard is issued and it becomes effective unless vetoed by one of the board's three sponsors during a 90-day waiting period. To date, 18 statements of federal accounting standards have been adopted by this procedure. In October 1999, the American Institute of Certified Public Accountants (AICPA) recognised FASAB standards as Generally Accepted Accounting Principles (GAAP) for federal entities.

2.2. State and local accounting standards

Whereas the FASAB serves one government, the GASB sets financial reporting standards for 50 states and 87 000 local governmental units. The formation of the board itself has a long and complicated history.

The GASB's formation

The topic of relevant reporting standards for American state and local governments has been written about and debated since the early 1900s. Until 1984, guidance had been provided primarily by the National Council on Governmental Accounting (NCGA) and its predecessors under the sponsorship of the Government Finance Officers Association. The AICPA also became involved as its members were engaged to perform independent audits on many municipalities and some states. However, NCGA standards lacked the authoritative recognition as GAAP that the AICPA had given the FASB standards. Also, inadequate resources limited the ability to research, deliberate, and issue the standards necessary to improve state and local governmental financial reporting.

In 1984, the organisations concerned with state and local governmental financial reporting signed an agreement establishing the GASB as an arm of the Financial Accounting Foundation (FAF), which also sponsors the FASB. The FAF was incorporated in 1972 as a not-for-profit organisation, and its trustees are responsible for selecting GASB and FASB members and for providing funding for, and exercising general oversight over, these boards and their advisory councils. Funding for both organisations comes from businesses, audit and accounting organisations, and governments.

The organisations that signed the GASB structural agreement included the Council of State Governments; Government Finance Officers Association; International City Management Association (now known as the International City/County Management Association); National Association of Counties; National Association of State Auditors, Comptrollers and Treasurers; National

Conference of State Legislatures; National Governors' Association; National League of Cities; and U.S. Conference of Mayors. This list is noteworthy for its breadth and the inclusion of groups representing the political and managerial leadership in the state and local government sector. In addition, two of these organisations – the Government Finance Officers Association and the National Association of State Auditors, Comptrollers and Treasurers – became sponsoring organisations of the FAF and as such joined the six private-sector sponsoring organisations responsible for nominating FAF trustees.

The mission of the GASB

The GASB's short mission statement calls for the board to establish and improve standards of state and local governmental accounting and financial reporting that will:

- result in useful information for users of financial reports; and
- guide and educate the public, including issuers, auditors, and users of those financial reports.

In 1986, the AICPA officially recognised the GASB as the authoritative body responsible for establishing GAAP for state and local governments. That recognition, enforced through the AICPA's rules of professional conduct for its members, lacks the legal authority to *require* state and local governments to prepare, and have audited, annual financial statements in accordance with GAAP. Each state retains its own sovereign right to determine the reporting of its financial operations. In some states, the state dictates local government financial reporting and audit requirements, and in other states the decisions are left to the local governments. So why would these state and local governments follow the standards established by the GASB?

One answer to that question is the encouragement, and in some cases, requirements, by those who loan or finance government debt and by those involved in these financing processes, such as lenders, bond rating agencies, and underwriters. Capital markets require the transparency of financial transactions to operate effectively, and GAAP reporting provides that transparency. Another factor is government officials' desire to maintain credibility with their taxpayers. Also, individual finance officials cherish recognition by their constituents and their superiors for complying with professional standards. There has also been an increased recognition by government officials that GAAP reflect sound business practices for governments. GAAP-based financial reporting has increased significantly in the past 15 to 20 years.

2.3. The relationship of the three standards boards

What is the relationship of the three separate accounting standards boards in the United States? Each board has a very defined role and jurisdiction. FASAB standards apply to the federal government and all of its related departments, agencies, and institutions. GASB standards apply to all state and local governments, which includes many special (*i.e.* single-function) districts, agencies, and institutions such as hospitals and colleges and universities. Indian tribes are also recognised by treaty and other agreements as sovereign governments. However, since they are not part of the federal government, they fall under the GASB's standards-setting jurisdiction. All other for-profit and not-for-profit organisations fall under the FASB's standards-setting jurisdiction. Although the boards are completely independent from each other, there is ongoing contact at the staff level and occasional contact at the board level to share ideas and thoughts on closely related projects. Also, as staff on one of the boards starts research on a project, if a related project has already been addressed by another board, those related conclusions and discussions become a valuable part of that research.

The disadvantage to having three independent boards in a country is the increased cost of standards-setting. The advantage is that each board is responsible for one set of organisations and can address their unique characteristics and the needs of their users and other constituencies. Hopefully, this results in higher-quality and more user-friendly standards for each of the different types of organisations.

3. The traditional American Government accounting model

3.1. Fund accounting on the cash basis

Fund accounting

Historically, American Governments created separate "funds" to keep track of money restricted for different purposes. For example, the fees collected on a toll road for maintenance would be kept separate from the money for paying off debt issued to construct the roads. These same "fund" accounting concepts were often incorporated into a government's budgetary processes.

From cash to modified accrual

American governments traditionally budgeted, operated, and reported on a cash basis of accounting. However, since cash basis could easily be manipulated, there was an agreement that annual financial reporting should be based on more disciplined accounting principles. It was also acknowledged that since governments were primarily focused on the short-term collection and use of financial resources, governmental fund financial reporting should similarly stress short-term financial resources rather than capital assets and long-term debt. This short-term emphasis was also supported by governments that believed that the power to tax their citizens reduced the worry about their ability to continue to operate. Those who purchased government debt obligations also believed this "power to tax" was sufficient to ensure that their bonds and other forms of debt would be repaid, so annual financial reporting historically was not considered all that important for governments. The exception to this generalisation about the short-term focus is government-owned business enterprises such as water systems. Governments and financial statement users are interested in these enterprises' operating results and the allocation of their significant capital costs to the users of these services.

With the focus on short-term activities, there came the concept of "modified accrual accounting" with its focus on the inflows and outflows of current financial resources. However, the modification should not be stretched to defeat the basic principle of accrual. For example, a government could not defer the payment date of a monthly payroll to the first day of the next fiscal year so as to avoid recognising the cost of salaries in the current year. Nor could the government delay paying invoices from vendors and suppliers until the next fiscal year in order to not recognise the cost of goods or services provided in a fiscal year.

Though these principles were in place, few states saw the need to follow them or even to produce audited financial statements. Budgetary practice was generally on a cash basis, which is a conservative way to recognise a government's revenues. Budgeting and recording cash outflows as a measure of expenditures is easy to understand and provides fairly consistent accounting if it is not manipulated. In addition, elected officials liked the "flexibility" provided by operating on a cash basis.

This budgetary "flexibility" was convenient to elected officials as governments experienced fiscal stress in the 1960s, 1970s and 1980s. Governments that had been budgeting revenues from taxes on a cash basis now changed practices and in some cases budgetary laws, allowing them to recognise as revenues taxes received weeks or months after the end of a fiscal year. This one-time windfall –such as 13 to 15 months of sales taxes recognised in one fiscal year – resulted in extra revenue to help balance a budget. However, it required the government to continue to operate on the new revenue recognition timetables or to face shortfalls, such as less than 12 months of sales taxes in another fiscal year. During severe budget crises, some governments also resorted to delaying the payment of wages or other bills to avoid recording expenditures on their books.

Although these flexible practices may have been allowed by budget laws and regulations, they generally were not allowed by generally accepted accounting principles (GAAP). However, since many governments did not issue audited annual financial statements, and since many did not report on the basis of accounting required by GAAP, these flexible accounting practices and the resulting deterioration of the government's financial condition were not highlighted. This situation has changed in the past two decades.

3.2. Toward GAAP-based financial statements

In the 1960s and 1970s, and even earlier when few states prepared financial statements based on GAAP themselves, a number of them required their *local* governments to prepare and have audited such statements. Other states required local governments to have annual audits but did not specify the method of presentation. In a few cases, states required a method of presentation for local governments that was not based on GAAP. Beginning in the late 1970s and extending into the 1980s, a number of events occurred that would lead almost all states to issue audited GAAP-based statements by the 1990s. These events included:

First, many governments recognised that their "power to tax" was not so unlimited that it could always be exercised to bail them out of a fiscal crisis. In the 1970s and 1980s, a number of local governments were in such bad financial shape that investors would not lend them money. Although they could legally raise taxes, their local economies could not sustain higher taxes. Consequently, there was an appreciation of the value of an annual financial statement that could be used to assess a government's fiscal performance. State governments, while not facing such severe fiscal crises, also were experiencing budget shortfalls and recognised the need for better financial information.

Second, the financial community – rating agencies and underwriters of government securities – began to inform governments that the lack of audited financial statements based on GAAP could adversely affect their credit ratings and consequently increase their borrowing cost. These warnings came at a time of increased government borrowing for infrastructure and other purposes, so state governments were particularly sensitive to this message.

Third, the federal government wanted audited financial statements from state and local governments before it would provide them with grants and contracts for road construction, health and welfare, education, and other services. It is ironic that the federal government was not preparing and issuing audited financial statements at that time, yet it required state and local governments to do so.

The increased emphasis on audited GAAP-based annual financial reporting led to the realisation that many governments' financial reporting practices were inadequate and needed to be improved. Existing governmental accounting standards met several important, but primarily short-term, objectives. It was the GASB's challenge to achieve other, generally longer-term, objectives of setting standards to provide an overall picture of a government's financial position and results of operations, including accounting for a government's use of capital assets.

4. The GASB'S conceptual framework and major standards

The GASB realised at the outset that it was important to have a sound conceptual framework to guide the development of specific accounting standards. That required the clear identification of the objectives of government financial reporting based on user needs.

4.1. Users and uses of financial statements

Accounting and financial reporting are essential to the efficient and effective functioning of our democratic system of government. Financial reports play a major role in fulfilling government's duty to be publicly accountable, because they are used to assess that accountability and to make economic, social and political decisions by many people who have the right and the need to know the government's financial affairs.

The GASB regards the primary users of state and local government's financial reports to be those:

- to whom government is primarily accountable: its citizens;
- who directly represent the citizens: legislative and oversight bodies; and
- who finance government or who participate in the financing process – taxpayers, other governments, investors, creditors, underwriters, and analysts.

Government administrators are also users of financial reports. They are considered primary users if they do not have ready access to internal information.

4.2. Objectives of financial reporting

In response to these user needs, the GASB articulated a set of objectives of financial reporting in Concepts Statement 1. In the GASB's operations, Concepts Statements guide the board's work of establishing standards by providing a frame of reference for resolving issues. They also help to establish reasonable bounds for judgement and assist the public in understanding the nature and limitations of financial reporting. These objectives of financial reporting are built on several basic premises, including:

- Financial reporting helps fulfil governments' duty to be publicly accountable. The duty to be publicly accountable is more significant in governmental financial reporting than in business enterprise financial reporting.
- Financial reporting is not an end in itself but is intended to provide information useful for many purposes.
- Financial reporting also helps to satisfy the needs of users who have limited authority, ability or resources to obtain information and who therefore rely on the reports as an important source of information.
- Financial statements are the core of financial reporting to external users.

- Other types of financial reporting exist beyond the basic financial statements. These reports, such as budget reports and reports to grantor agencies, exist to meet special-purpose reporting needs, and often these reports are not prepared on a GAAP basis of accounting.

In Concepts Statement 1, the GASB takes a broad view of public accountability and anticipates that not all financial reporting objectives can be accomplished through general-purpose financial statements. These financial statements, designed to meet the common needs of the users identified earlier, to date have been the primary focus of all 36 GASB standards. Thus, currently the expression "GAAP-based financial statements" refers to general purpose financial statements. As noted at the end of this paper, the GASB continues to do research on longer term projects that may result in GAAP standards for reporting beyond general purpose financial statements. The board's new financial reporting model, as set forth in Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, affects many of the prior GASB statements. The new financial statements, prepared in accordance with Statement 34, are expected to meet, as much as possible, the nine financial reporting objectives identified in Concepts Statement 1 (see Box 1).

4.3. New reporting model

Since the traditional governmental accounting and reporting model falls short of many of these objectives, almost from its inception the GASB undertook to redesign the model. This reporting model project has resulted in Statement 34 mentioned earlier. Statement 34 has attempted to incorporate as many of the reporting objectives identified in Concepts Statement 1 as possible into a government's basic financial statements. These financial statements focus on a government's significant individual funds as well as the overall financial position of the government. They focus on the inflows and outflows of current financial resources as well as the total costs of providing government services. As the new reporting model will be discussed in the Annex, I will focus here on the long process that produced it.

Box 1. Financial reporting objectives

Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability.

a) *Financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.* This also implies that financial reporting should show whether current-year citizens received services but shifted part of the payment burden to future-year citizens; whether previously accumulated resources were used up in providing services to current-year citizens; or, conversely, whether current-year revenues were not only sufficient to pay for current-year services, but also increased accumulated resources.

b) *Financial reporting should demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget; it should also demonstrate compliance with other finance-related legal or contractual requirements.*

c) *Financial reporting should provide information to assist users in assessing the service efforts, costs and accomplishments of the governmental entity.* This information, when combined with information from other sources, helps users assess the economy, efficiency and effectiveness of government and may help form a basis for voting or funding decisions. The information should be based on objective criteria to aid interperiod analysis within an entity and comparisons among similar entities. Information about physical resources should also assist in determining cost of services.

Financial reporting should assist users in evaluating the operating results of the governmental entity for the year.

a) *Financial reporting should provide information about sources and uses of financial resources.* Financial reporting should account for all outflows by function and purpose, all inflows by source and type, and the extent to which inflows met outflows. Financial reporting should identify material nonrecurring financial transactions.

b) *Financial reporting should provide information about how the governmental entity financed its activities and met its cash requirements.*

c) *Financial reporting should provide information necessary to determine whether the entity's position improved or deteriorated as a result of the year's operations.*

Financial reporting should assist users assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due.

a) *Financial reporting should provide information about the financial position and condition of a governmental entity.* Financial reporting should provide information about resources, and obligations, both actual and contingent, current and non-current. The major financial resources of most governmental entities are derived from the ability to tax and issue debt. As a result, financial reporting should provide information about tax sources, tax limitations, tax burdens, and debt limitations.

b) *Financial reporting should provide information about a governmental entity's physical and other non-financial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources.* This information should be presented to help users assess long- and short-term capital needs.

c) *Financial reporting should disclose legal or contractual restrictions on resources and risks of potential loss of resources.*

A long due process

Expanding governmental financial reporting from a short-term budgetary focus to include longer term overall financial position and results of operation was a lengthy and difficult process. The process took the GASB over 10 years. During this period, the board expanded from five to seven members. In response to negative feedback, a basic change in direction took place as board member turnover also occurred. Change in life is difficult and requires significant effort. It requires people to move outside their comfort zone, to learn new things and think differently, and it challenges the logic previously applied to a given circumstance. Many finance officers and some board members initially opposed the significant change to better incorporate most of the objectives of Concepts Statement 1 into basic financial statements. Their objections were considered as part of the GASB's open "due process" (a structured deliberative process with steps designed to enhance the acceptance of the results). According to our Rules of Procedure, the board is required to:

- Weigh carefully the views of its constituents in developing concepts and standards so that they will:

  - meet the accountability and decision-making needs of the users of government financial reports; and

  - gain general acceptance among state and local government preparers and auditors of financial reports.

- Establish standards only when the expected benefits exceed the perceived costs. The GASB strives to determine that proposed standards (including disclosure requirements) fill a significant need and that the costs they impose, compared with possible alternatives, are justified when compared to the overall public benefit.

- Consider the applicability of its standards to the separately issued general purpose financial statements of government-owned special entities. The GASB specifically evaluates similarities of special entities and of their activities and transactions in both the public and private sectors, and the need, in certain instances, for comparability with the private sector.

- Bring about needed changes in ways that minimise disruption of the accounting and financial reporting processes. Reasonable effective dates and transition provisions are established when new standards are introduced. The GASB considers it desirable that change should be evolutionary to the extent that can be accommodated by the need for understandability, relevance, reliability, comparability and consistency.

- Review the effects of past decisions and interpret, amend, or replace standards when appropriate.

In the course of implementing the above due process requirements for adopting Statement 34, the GASB issued several different documents for public comment and held more than a dozen public hearings at various locations around the country. It also held approximately two dozen in-depth interviews with user groups such as financial analysts, media representatives, taxpayer watchdog groups, and governing board members. We also received approximately 1 000 letters commenting on the various proposals. In addition, one of our constituent organisations encouraged its members to protest the proposed requirement to report on infrastructure assets. As a result, approximately 1 500 letters of opposition were received on this specific issue.

The board members themselves come from different backgrounds and are representative of the GASB's different constituencies. They spent hundreds of hours in internal debates on various reporting provisions, both before and after those provisions were exposed for public comment. In the end, the board members' individual positions reflected the varied interests of the GASB's constituents. There are portions of Statement 34 that each board member believes significantly improve the financial reporting of governments. Yet there are other provisions that some board members wanted to change but had failed to get a majority support. What one board member saw as a significant improvement, another saw as unnecessary change. What one member saw as an important reporting feature to be retained, another saw as a backwards practice to be abandoned. In other words, Statement 34 is a blending together and a compromise of strongly held views of the board members and constituents' feelings.

In the end, all seven board members voted in favour of Statement 34, because they saw much more positive improvement than unnecessary change or not enough change. The GASB's constituents generally are supportive of Statement 34. On the issue of requiring infrastructure reporting, some would have liked it dropped, yet others saw it as one of the best improvements.

An assessment of the new reporting model

Tens of thousands of local governments and scores of state governments in the United States are now beginning to implement GASB Statement 34. When these governments issue financial statements based on Statement 34, will the financial statement fulfil all the objectives of accountability set forth in Concepts Statement 1? The answer is no. As the GASB acknowledged in the Concepts Statement, some aspects of governmental fiscal accountability may require reporting beyond that contained in basic financial statements. However, all objectives will be at least partially fulfilled, including several important objectives that were not met at all by the existing generally short-term focused financial statements. Some of these key objectives not previously addressed in governmental financial reporting, but they will be met in Statement 34 financial statements. They call for information to determine *i)* whether current-year revenues were sufficient to pay for current-year services; *ii)* whether the entity's financial position improved or deteriorated as a result of the year's operations; and *iii)* the service potential and other information about a governmental entity's physical and other non-financial resources having useful lives that extend beyond the current year. The following is a brief discussion of how these three key objectives are met:

1. *Were revenues sufficient to pay for current services?* Statement 34 requires the "cost" of a service to include the allocated portion of capital assets used up during the period to provide that service. For instance, in a city providing fire protection, budgetary resource needs are significantly higher in years that a new fire truck is purchased or a new fire station is built. If you focus only on the flow of current financial resources, you will have a very good idea of what a government spent its money for in any given year. However, it is not possible to

determine the actual cost of providing that fire-protection service in a way that will give a meaningful, consistent comparison of that cost from year to year within the government, nor can the cost be compared against other, similar-sized governments. By capitalising the cost of those significant assets and depreciating them over their useful lives, a government can provide meaningful comparative information to help it better manage its costs of services. In addition, outside users of these financial statements can use this information to compare one government against others and have some idea of a government's efficiency in delivering these services.

It should be noted that other relevant information about service delivery must also be considered along with the cost of that service before one can make a more knowledgeable assessment of a government's efficiency and effectiveness. Statement 34 calls for a government to report on the cost of each of its significant services or functions and to identify how much of that service is paid for by those who use the service and by other governments versus the general taxpayers of the government.

2. *Is the government's financial position improving or deteriorating?* A government's focus on budgetary resources or current financial resources may give an indication of an improving or deteriorating financial position as these resources increase or decrease; however, this focus can be distorted by a number of factors. A government may borrow money, which increases its current resources available to be spent, but one could hardly say its financial position has improved. Or the government could reduce or eliminate any spending for capital assets or their maintenance, thereby having more current financial resources. Again, one would not consider such a government as having an improving financial position, because it has more current resources but a deteriorating infrastructure.

Statement 34 calls for the accounting for capital assets and the combining of short-term and long-term assets and liabilities. This helps users determine a financial position of a government and have the information to assess its improving or deteriorating financial position.

3. *Is all the information users would like about capital assets in the new reporting model?* Statement 34 does not provide all the information users would like about a government's capital assets. Most commonly identified users' needs include the desire for information about the condition of a government's capital assets and their remaining service lives. The basic provision called for in Statement 34 is that a government must account for its capital assets, including its infrastructure, and must depreciate these assets over their useful lives. This depreciation expense is reflected in the costs of the various government services in order to determine the actual cost of providing those services. Although that information does not directly provide information on the condition of capital assets and their remaining service lives, the comparison of the cost of an asset to its accumulated depreciation does give an indication of its condition and remaining service life.

   One of the GASB's future projects on economic condition will examine the need for, and the reasonableness of providing, additional information on capital asset condition and service potential. An option was provided in Statement 34 for governments that do not want to depreciate their infrastructure because they believe they are maintaining the infrastructure in such a manner that it is not depreciating. This option requires a statement of intent from the governing body and a series of condition assessments, and disclosure of planned maintenance versus actual maintenance disclosures. If those disclosures reflect the fact that the government's infrastructure is being maintained in a consistent manner, the government is not required to report the depreciation of its infrastructure.

4.4. Observations about the standards-setting process

The GASB's decision-making process may strike some people as inefficient. They ask: Does due process improve the GASB's standards? I believe the answer to that question is yes, due process definitely improves the GASB's standards. Positions on issues are clarified and arguments for alternatives are sharpened in the various "due process documents" such as Discussion Memoranda, Preliminary Views, and Exposure Drafts, all of which lead to a final Statement. To illustrate this point, I will share a few specific examples of changes to Statement 34 as a result of feedback from the due process.

I became a board member in 1994, several years after work on the reporting model had begun. Early turnover of the original board members had resulted in a three-to-two decision to modify the intended direction of the original board, but there was little agreement about the direction of the new board. Early in 1995, all board members agreed on a basic direction for the reporting model project that ultimately resulted in the issuance of Statement 34. However, there were many individual features of the model where there was significant disagreement among the board members.

I will briefly address three specific features of the new model that I believe significantly improved the model when the board made changes as a result of feedback during the due process. I have chosen these three among many others because they were some of the issues that I had argued strongly for before the GASB issued its due process documents for comment, but I had failed to convince a majority of board members to support my position.

First, the 1995 Preliminary Views document called for government-wide financial statements in a single total column, without separately identifying the governmental activities (normally financed with taxes) separately from the business-type activities (normally financed with user fees). That separation had been made earlier and seemed to have support, but the majority of board members opposed it.

Second, the preliminary views document did not separate the net assets of a government into those that were restricted, those that related to capital assets, and those there were unrestricted. The majority of respondents to the preliminary views document supported both of those features, and without much additional argument the majority of the board agreed to change their positions and support those features.

The third feature was far more controversial. The 1995 Preliminary Views document was based on a premise of “dual-perspective” reporting. That premise was that governments should have two sets of financial statements: one based on the existing fund-based modified accrual accounting, and another based on looking at the whole government, without regard to fund structures, on an accrual basis of accounting. Both of these two sets of financial statements would be required for fair presentation in accordance with GAAP, but they would not be reconciled to each other. This dual-perspective concept was strongly rejected by government finance officials and independent auditors. However, despite this opposition and my urging the board to modify this dual-perspective concept, the next due process document, an exposure draft leading to a final standard, was issued with the same “dual-perspective” notion.

Whereas respondents to the exposure draft reacted positively to most of the changes the GASB had made, including the two mentioned earlier to the government-wide statements, they continued to be very negative to the dual-perspective notion. Even users of financial statements who were quite positive toward the new reporting model were concerned about understanding the relationship of the two sets of statements. After all, the same events and transactions give rise to both sets of statements, even if those events and transactions are being measured differently.

The majority of board members continued to oppose the suggested reconciliation of the two sets of financial statements, despite all of the due process feedback received. After careful deliberation, in the end, however, they agreed to this reconciliation on the face of the fund financial statements. This action has resulted in much greater acceptance of the new reporting model by the GASB's constituency. Lest one gets the wrong impression that the board chairman always gets his way, let me state that I have no greater voting authority as chairman than any other board member. I lost just as many board debates over specific provisions in Statement 34 as I won.

Although due process feedback influences the board's actions, it should not be misconstrued as a popularity contest, or a way for respondents to feel like they are voting on a standard. The GASB looks for the substance and logic of the feedback rather than sheer numbers. For example, despite the letters from over 1 500 government finance officials opposing the reporting of infrastructure capital assets, the GASB kept that requirement. In response to those letters, the GASB did extend the implementation period for reporting infrastructure, particularly to smaller governments. However, since the letters failed to explain how a government could measure its financial position or results of operations without including infrastructure, the GASB was not convinced to change its proposal based simply on the sheer volume of letters.

5. Public accountability and the future

5.1. Back to public accountability

Many important features in Statement 34 enable a government's financial statements to reflect its public accountability to those who finance governments and those whose lives are impacted by a government's actions. I have provided a few examples to support the proposition that government financial reports prepared on an accrual basis of accounting are necessary for users to assess a government's fiscal accountability. However, cash basis or modified accrual basis budgetary accounting and reporting also provides useful operational information. Both measures are important, and most governments will probably always continue to operate on a cash or short-term basis. However, their financial statements should tell the whole story of their ever-changing financial position and results of operations. In this way, government officials, investors, and taxpayers will be able to make more informed decisions about their governments.

5.2. Looking to the future

When people ask me what the GASB is going to do now that we have completed the reporting model project, I often tell them that an improved reporting model is the beginning, not the end, of improved accountability reporting. Earlier in Box 1, I outlined the nine financial reporting objectives set forth in GASB Concepts Statement 1. The first category of objectives deals with public accountability and providing information to users to assess that accountability. The third specific financial reporting objective in this category deals with providing service efforts and accomplishments information that would be helpful to users in assessing the economy, efficiency, and effectiveness of their governments. Without doubt, this is the kind of information that would be most important to the citizens in the United States, and yet it is also the hardest information to provide in the basic financial statements of a government.

This financial reporting objective on service efforts and accomplishments was one that was only slightly addressed in Statement 34. The new reporting model does provide a platform to start assessing service efforts and accomplishments by identifying each of the government's main programs or function and providing consistent information about the costs of these programs. However, much more information is necessary for users to fully assess the economy, efficiency, and effectiveness of their governments. The GASB has a significant separate research project on this issue which is being funded in part by a private foundation.

Several of the GASB's constituencies, primarily representing financial statement preparers, strongly oppose the GASB's setting standards for service efforts and accomplishments reporting because they believe this type of financial reporting goes beyond traditional financial statement, which they believe the GASB should focus on. Meeting this financial reporting objective completely will be a very difficult challenge for the GASB in the coming years because much of the information that users need will have to be provided outside of basic financial statements. The GASB acknowledged that when

Concepts Statement 1 (already discussed) and Concepts Statement 2 (on service efforts and accomplishments) were issued. We continue to encourage state and local governments to experiment with service efforts and accomplishments reporting until such time as the GASB completes this project.

Other current and future GASB projects also focus on information needs not completely met in Statement 34. We are just completing a project to improve financial statement footnote disclosures. We also have a project to recognise the financial impact of promises made to employees to continue to provide healthcare insurance to them after they retire. Other longer term projects include having government financial statements reflect environmental liabilities and information about the condition of infrastructure and other long-lived assets. Much work remains to be done to improve financial reporting to enable governments to better convey information about their fiscal accountability.

In addition to our technical agenda projects, we are also working to help governments implement the new reporting model and are helping financial statement users in knowing how to use the new information to better understand their governments' finances. The GASB has issued a comprehensive implementation guide on Statement 34 and has issued a series of user guides to help government officials, taxpayers, analysts, and others know how to use the new financial statements to more fully understand and analyse a government's finances. We are just starting to issue certificates of recognition to the governments that implement the new reporting model early. We also contact their local news media to ask them to acknowledge the efforts of their local finance officials who are implementing Statement 34 early. To date, 20 governments have implemented the new model, and we anticipate that several hundred others will implement it earlier than required by the standard.

In addition to our domestic agenda, we look forward to participating in the international accounting standards arena in the hope that governments from around the world will be able to assist each other in improving financial reporting standards. All governments will benefit from the increased credibility we will receive, as we do a better job of communicating our financial stewardship to our constituents.

Finally, I believe the GASB's power lies not in what it can force upon someone, but in its ability to convince, through open due process, that its proposed changes are in the best interest of all constituents.

ANNEX
A BRIEF SUMMARY OF GASB STATEMENT NO. 34
JAMES L. CHAN

Through its Statement No. 34 (issued in June 1999), the Governmental Accounting Standards Board (GASB) has made some unprecedented changes to the way American state and local governments report their financial affairs. The purpose of this note is to briefly summarise the requirements of the Statement, which is entitled "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments."

GASB 34 is applicable to all American state and local governments. These include multi-function general governments (*e.g.* states, cities, villages and towns) and single-function special districts (*e.g.* school districts and park districts). The Statement requires them to improve their financial disclosures to external users, such as the citizenry, legislative and oversight bodies, and participants in the municipal bond markets. The Statement provides for:

- management's discussion and analysis (MD&A) giving an objective and analytical overview of the government's financial activities; and

- basic financial statements consisting of government-wide financial statements and fund financial statements.

Management's discussion and analysis

The GASB requires this overview to help users assess whether the government's financial activities during the past year have strengthened or weakened its financial position. In particular, the MD&A is required to:

- include government-wide financial comparison of the current and previous fiscal years;

- cover the government's overall financial position and results of operations;

- disclose significant changes in the government's funds and significant budget variances;

- describe capital asset and long-term debt activities during the year; and

- state the currently known facts, decisions or conditions that are expected to affect the government's financial future.

With the MD&A, a government's chief executive (*e.g.* a governor or a mayor) can directly communicate with his/her constituencies about its finances. Even though it is primarily based on past activities and events, the discussion and analysis is oriented to the future and can include information about the fiscal year in progress, as well as information about a government's financial future. Thus the MD&A complements the historical nature of financial statements.

Government-wide financial statements

The government-wide financial statements would present governmental activities and business-type activities in two separate columns. Fiduciary resources, such as employee pensions, that are not available to finance the government, are excluded. Most significantly, the full accrual basis of accounting is used to prepare a statement of net assets and a statement of activities. The key elements of these financial statements are assets, liabilities, revenues and expenses (as well as gains and losses). Assets encompass all financial and economic resources, and both short-term and long-term liabilities are to be presented. All capital assets (including infrastructure assets) are to be reported in the government-wide statement of net assets, and the depreciation expense in the statement of activities (except under limited circumstances). In general, the statement of activities is designed to show whether current operations have made government better or worse off in terms of having more or less economic resources.

Traditionally, the balance sheet shows assets as being equal to liabilities plus equity. By means of the net asset concept and format of assets minus liabilities, the GASB emphasises the amount of net resources to be carried over to the next period. However, in recognition of the varying degrees of liquidity and discretion associated with the different classes of net assets, the board requires their reporting in three categories: net assets invested in capital assets net of related debt, restricted net assets, and unrestricted assets. Furthermore, permanent endowments and the like are classified as expendable and non-expendable.

The statement of activities covers the same entities as the statement of net assets, and similarly show governmental and business-type activities separately. Statement 34 also endorses the inverted format for the statement of activities. That is, the amounts of expenses are first listed and revenues are subtracted from them to show the net cost of services to the general public. More specifically, the expenses – not expenditures – of each service activity are offset by a combination of "program revenues" – user fees, operating or capital grants and contributions. The resulting figures show the amounts that were financed by *general* revenues.

Fund financial statements

The second set of basic financial statements are the fund financial statements. Currently, combined financial statements present financial information by fund type. The fund types are: (a) governmental funds: the general fund, special revenue funds, capital projects funds, and debt service funds; (b) proprietary funds: enterprise funds and internal service funds; and (c) fiduciary funds: trust funds, agency funds.

GASB No. 34 requires the fund financial statements to stress the government's *major* governmental, enterprise funds and fiduciary funds. Similar to current practice, the new governmental fund statements are to be prepared using the "current financial resources" measurement focus and the modified accrual basis. These statements will include a balance sheet; and a statement of revenues, expenditures and changes in fund balances. Proprietary fund financial statements will continue to be prepared using the "economic resources" measurement focus and the accrual basis of accounting. They consist of a statement of net assets; a statement of revenues, expenses and changes in fund net assets; and a statement of cash flows.

Separate columns are provided for the general fund and for other major governmental and enterprise funds. The aggregates of all non-major funds are reported in a separate column. Internal service funds are separately identified in the proprietary fund statements.

The government-wide and fund statements are not like the combined and combining financial statements in the current reporting model. There, the subtotals of the combining statements of a particular fund type are "rolled" up to the combined financial statements. In the new model, the government-wide and the fund financial statements encompass different entities and use different measurement rules. Consequently, GASB 34 requires a summary reconciliation of the two levels of reporting to help users understand their relationship.

Other required supplementary information

Required supplementary information (RSI) other than the MD&A includes budgetary comparison schedules for the general fund and for each major special revenue fund with a legally adopted annual budget. The schedules, prepared using the government's budgetary basis, should present the original budget, the final budget, as well as actual inflows, outflows and balances. Governments are therefore discouraged from revising revenue estimates or appropriations in order to avoid the reporting of unfavourable budget variances. Since budget revisions during the year are revealed, users are prompted to inquire about major departures from the original numbers.

Comparison with current requirements

As GASB 34 is voluminous and complex, this paper has identified its main provisions. In order to highlight the departures of GASB 34 from current requirements, Table 1 provides a comparison along the major dimensions of accounting policy.

Effective dates

Because of the extensive changes required, the GASB has adopted a gradual approach to implementing the Statement 34 based on the size of government measured in terms of total annual revenue for fiscal year 1999. The larger the government is, the earlier is the effective date. The standard will impact the statements for fiscal year beginning 15 June 2001 for large government ($100 million or more), 15 June 2002 for medium-size government ($10-$100 million), and 15 June 2003 for small governments (less than $10 million).

Table 1. **A comparison of current and new requirements**

Dimension	Current Requirements	GASB 34 Requirements
Report Structure	Pyramid model: combining statements of funds aggregated to combined financial statements by fund type.	Dual perspective: the government-wide perspective; and the major funds and other funds.
Management's Discussion and analysis	Not required; wide management discretion as to content and style in letters of transmittal.	Required supplementary information with specific guidelines as to content.
Basis of Accounting	Depends on nature of funds and activities financed: Full accrual for business-like funds; modified accrual for governmental funds.	Depends on financial reporting perspective: full accrual for government-wide statements; no change for fund financial statements.
Relative Emphasis	Current operations (statement of activities) receives greater emphasis.	Financial position (statement of net assets) receives greater emphasis.
Statement of Activities	Shows the use of available resources.	Shows the net expense of services to be financed by general revenues.
Budget Comparison	Actual vs. latest revised budget, using budgetary basis.	Actual vs. original and revised budgets, also using budgetary basis.
Fixed Assets	Included in funds if belonging to proprietary funds; reported in account group if belonging to whole government; infrastructure excluded.	Reported in government-wide financial statements, supported by schedules; not included in governmental type funds.
Depreciation of Fixed Assets	Depreciation expense and net book value reported in case of fixed assets of proprietary funds; no depreciation expense reported for general fixed assets.	Depreciation expenses and net book value reported for all fixed assets, with certain exceptions.
Long-term Debt	Included in funds if incurred by proprietary funds; reported in account group if belonging to whole government.	Reported in the government-wide financial statements, supported by schedules.
Account Group	General fixed assets account group and general long-term debt account group required.	Account groups are abolished; substantive disclosures via schedules and notes.

BETTER PUBLIC SECTOR GOVERNANCE: THE RATIONALE FOR BUDGETING AND ACCOUNTING REFORM IN WESTERN NATIONS
BY

ALEX MATHESON[*]

The topic of this conference – government budgeting and accounting reform – could not be more current in the world of public management. Many countries in the Organisation for Economic and Co-operation and Development (OECD)[1] are currently engaged in rethinking their budgetary and accounting frameworks. At first look, accounting and other budgeting reforms seem like technical discussions. Yet, sound budget and accounting practices have far-reaching implications for a nation's growth and are a key element of good governance structures. Indeed it is in this context of governance that I would like to frame my presentation today.

My presentation today is in two parts. First, I will talk generally about what we at the OECD see as good governance. Second, I will discuss how modern budget practices support that framework of governance, and what the OECD does to that end.

1. Good public governance

The OECD believes strongly that sound governance is necessary for economic stability and social cohesion. I would like to take a moment to discuss the word "governance" because it is sometimes casually used and often misused to represent several ideas. By governance, I mean the way power is embodied in public institutions and is exercised, as well as arrangements that keep policy-making sound over time. The concept of governance incorporates how decisions are made, the balance of powers and institutions, and in ways politicians and managers are held accountable. It refers not to public policies *per se*, but to the settings within which public policy is decided and executed.

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When it is effective, governance serves to provide:

- an environment in which people are treated fairly and equitably;
- an atmosphere of transparency which limits monopolistic behaviour and stimulates efficiency and innovation;
- stability and predictability for social investments;
- a way of bringing coherence to diverse policy objectives, including both short and long term interests; and
- separated responsibilities and accountabilities to prevent the misuse of power by individuals or groups.

There is of course no universal model or structure for effective public sector governance. Nevertheless, the experiences of a growing number of countries – both Members and non-members of the OECD – point to a common agenda for improving governance arrangements, OECD Member countries are committed to strengthening governance structures to reap the economic and social benefits of a global economy. Sound governance in both the private and public sector is a precondition for the benefits of a modern economy and increased global trade and investment. Indeed, it should be stressed that the public sector and governance itself should not be considered in isolation. The Secretary-General of the OECD, Donald Johnston, often talks of the "triangular paradigm" of governance, social cohesion and economic growth.

The OECD has identified several attributes of good public governance. These include:

- Transparency – open processes and systematic reports on results in meeting objectives;
- Accountability – actions, decisions and decision-making processes open to scrutiny by public agencies, Parliament and civil society;
- Responsiveness – the capacity and flexibility to respond to changing national and international circumstances;
- Future Orientation – the ability to anticipate future problems and develop policies that take into account future costs and anticipated changes;

- Rule of Law and Integrity – equitable enforcement of transparent laws, regulations and codes, so that they become a part of the culture in the public sector in supporting ethical behaviour and in vigorous action to fight corruption.

These elements of good governance combine to promote a government's credibility, which in turn gives it legitimacy internally and respect externally.

2. OECD projects promoting good governance

2.1. Accounting, budgeting and governance

A sound and transparent budgeting and accounting architecture is a fundamental building block for good public sector governance.

OECD Member countries have enjoyed a period of economic good fortune. With the introduction of generally better budget practices, especially in controlling aggregate expenditure, this has led to declining budget deficits and in some cases even fiscal surplus. Within the OECD, the average fiscal deficit had declined from 4% to 1% in recent years. Yet while the current fiscal outlook is good, there are long-term problems facing OECD and other countries. There are looming risks of economic uncertainty and social conflict, and unavoidable consequences of ageing populations and environmental degradation.

The OECD is therefore supporting a more ambitious program to improve public budgeting and financial management to take better account of the future. This not only includes recognising major liabilities like public debt, pension schemes, social benefit entitlement schemes and public insurance schemes. It also includes recognising the future fiscal consequences of current patterns of behaviour, especially in light of the ageing population and environmental degradation. We are also working with our Member countries to make their budgeting institutions better at reallocating resources when national priorities change. For many countries, reallocation applies only to *additional* resources. This of course means that over time either government budgets keep expanding, or they stop adapting to new circumstances.

2.2. Fiscal transparency

At the heart of our work in the OECD is the need for a transparent or open fiscal process. From simple criminal embezzlement to poorly constructed or ill-timed financial information, the problems from a closed and confusing budget and accounting structure can affect the public's confidence in their government system. Transparency – openness about policy intentions, formulation and implementation – is a key element of good governance. The budget is the single most important policy document of governments. In the budget, policy objectives are reconciled and implemented in concrete terms.

Fiscal transparency requires the full disclosure of all relevant fiscal information – including budget information - in a timely and systematic manner. The OECD has therefore proposed a set of "Best Practices for Budget Transparency" (*OECD Journal on Budgeting*, 1:3). On the basis of a survey of OECD budget practices in all Member countries, these recommendations lay out a series of systematic steps on budget development and budget implementation to promote greater transparency. There are specific recommendations for the types of information that should be included in these reports. These include:

- the economic assumptions used to develop the budget;
- a statement of assets and liabilities of a government;
- tax expenditures – the estimated forgone revenue due to preferential tax treatments;
- recommendations for accountability, control and integrity of data.

2.3. Greater Independence for Fiscal Institutions[2]

The case for independent central banks with the power to use monetary instruments to maintain low inflation is now firmly established, and its positive effect on monetary policy is generally recognised. When governments cannot manipulate monetary policy for political purposes, there can actually be a better alignment of the interests of government with those of the citizens. Given the political nature of budgeting, such independence for fiscal institutions that determines tax rates and allocate resources is unrealistic and perhaps undesirable. However, certain aspects of fiscal policy, notably economic forecasting deserve more scrutiny and independence.

It is the experience of our Member countries that the use of excessively optimistic economic assumptions is a large risk. When a government is under heavy political pressure to make its promises affordable, there is a strong temptation to push up the growth and revenue projections rather than reduce spending plans. This is however a pathway to compounding deficits. Out of bitter experience, several Member countries have reformed the way their economic forecasts are produced. These changes have taken several forms including:

- creating an independent budget office for formulating or verifying economic assumptions;
- assigning a more active role by the legislature in reviewing assumptions; and
- giving Parliaments access to independent assessments of economic conditions.

2.4. Reallocation of budgetary resources

The reallocation of resources is at the heart of budgeting. As national conditions and problems change, the direction of government strategy – and therefore the budget – must be able to adjust accordingly for resources to flow to where they are most effective. However, there are inherent difficulties to reallocation. Great resistance to reallocation can be expected from those who are adversely affected, including the state agencies. Support from those who would benefit tends to be weak and diffuse, even though this group may be much larger. The challenge of governance is to devise a budgetary process that makes it more likely that the future interests of the many will prevail over the vested interests of the few.

In the past only external shocks or crises triggered the political will necessary for large-scale reallocations. The better the economic conditions are, the less likely that governments will make hard fiscal choices in the short-run to create systemic and sustainable public sector growth for the longer run.

Across-the-board budget cuts are common in OECD Member countries, especially for reducing the operating expenditures of government. In terms of end results, this approach serves to reduce deficits or to create a pool of resources to fund new initiatives. The cuts are also justified in terms of capturing productivity gains in the public sector. They also tend to be politically acceptable. However, across-the-board cuts are less desirable than the tougher choice of reallocating among ministries and across generations. In fact, there are limits to across-the-board cuts. If projections on future high spending come to bear, across-the-board cuts may be inadequate to avoid large future deficits. There should be a dialogue between governments and Parliaments now to avoid crisis changes in the future.

Possible answers include: giving more flexibility to managers, reducing interagency rivalry by enlarging the scope of budgets, focusing attention more on the desired societal outcomes, and lengthening time horizons.

2.5. Budgeting for the Future[3]

Budgeting by definition deals with the future. But annual budgets often ignore the long-term. Therefore we urge governments to budget for the future – the longer term. It is easy to call for dialogue on future needs than to address them in practice. I would like to talk about several specific changes that could frame this discussion.

Medium-term or multi-year budget frameworks

Most OECD Member countries have adopted some form of multi-year budget frameworks to address the insufficiencies of annual budgets. While they do not make legally binding multi-year allocations, these frameworks provide a guide or target for spending over the next three to five years. The force of such arrangements comes from the fact that they become public, thus putting governments under pressure from citizens and financial markets if they do not comply. Although, the practice has certain limitations, most countries have refined these medium-term plans to overcome difficulties such as:

- the tendency to over-estimate future growth in the economy;
- the incentive of departments to view the goals as entitlements to future funding, making downward revisions later difficult; and
- the practice of shaping frameworks in real rather than nominal terms. (When economic growth falls or inflation accelerates, expenditure forecasts are automatically adjusted.)

By overcoming these difficulties, effective medium-term frameworks can provide Parliaments and the private sector with credible information on overall fiscal policy targets with explicit assumptions, the cost of continuing existing programs, and the implications of current decisions on future budgets.

Long-term budget framework

In contrast to the general agreement on medium-term framework, the use of long-term budgets is neither as widespread nor as uniform across OECD Member countries. While the objectives of medium-term frameworks are operational in nature, long-term objectives are more strategic. The primary objective of long-term frameworks is to identify and expose adverse expenditure trends at an early stage. This will allow decisions to be taken in time to prevent, moderate or finance these expenditures. They enable countries to focus on the long-term sustainability of current policies. Otherwise such expenditures may go unnoticed until it is too late to equitably or properly address them.

Long-term frameworks are used principally to capture the impact of changing demography on government finances. By far the greatest future budget requirement in developed countries comes from serving an ageing population. If long-term frameworks incorporate only known demographic changes, suspicion of the projections is reduced and the projections are more acceptable. Other areas of expenditure are generally not forecast at a detailed level, but are assumed to change at set rates. The reasons are either the low level of spending in these areas, or the suspicion of the applicability and accuracy of long-term forecasts in general. At the extreme, some countries seem to reject long-term frameworks as a matter of principle.

I would note that the potentially devastating budgetary effect of environmental degradation is left out of virtually all long-term analysis. As you are all well aware, this is a highly controversial topic with few firm assumptions to use. Ignoring such potential risks may be costly, perhaps even a threat to long-term stability.

I will discuss two more concrete topics that inform future budgeting needs: accrual accounting and performance budgeting.

2.6. Accrual accounting

Currently half of OECD Member countries use some form of accrual accounting in their financial reporting, although only a few use accruals in their budget process. I should note that there is a distinction between accrual financial accounting and accrual budgeting.

- The budget is a future-oriented financial plan for allocating resources among alternative uses, both within the government and between governments, and between the government and the rest of the economy.

- Financial reporting retrospectively describes the results of an entity's financial transactions and events in terms of its financial position and performance. Indeed, only New Zealand and Australia use accruals in both financial reporting and in the budget. The United Kingdom, Canada and France have plans for more extensive use of accruals in the near future.

Accrual analysis required by private sector accounting standards has several implications for dealing with long-term budget horizons. First, revenues are recognised only when services are rendered not when cash is received. Expenses are recognised when economic resources are used, rather than when they are paid in cash. After a government has received services, the related obligations (*e.g.* employee retirement benefits) are also reported as expenses for the current period and as liabilities on the balance sheet. Second, all economic resources are regarded as assets in the balance sheet. For example, New Zealand recognises its highway and other infrastructures as assets, and records their depreciation as expense as well. This has led to a greater attention being paid to the management and maintenance of their values. Third, all government obligations for services received or commitments made are reported as liabilities in the balance sheet, even if they have not been funded in the budgetary process.

Extending accruals to budgeting is controversial. Much of that controversy arises from the government administration itself and Parliaments. Before this change is contemplated, a significant amount of time needs to be invested in educating and consulting with government managers and other interested groups, like parliamentarians. In those countries that have adopted accruals, the change has been linked to other public management reforms. Accrual accounting places a premium on confidence in audits and a willingness to accept fluctuations in valuations. Practice in Australia and New Zealand has shown that the use of accruals in the budget has led to a better realisation of future unfunded liabilities, better infrastructure management and a more efficient budget reallocation process.

2.7. Performance budgeting

Finally, a major theme of management reforms in OECD Member countries has been the shift in focus from inputs to results. This opens the possibility of allowing much greater managerial autonomy and flexibility. If performance is recorded, it can be assessed *ex post* rather than prescribed *ex ante*. This requires systems of accounting which can assign costs to result areas, and a capacity to treat information on performance with the same completeness and credibility as applies to financial information.

More ambitiously, a few OECD Member countries have replaced their traditional input and departmentally based budgets with budgets that stipulate performance at a government level. These performance budgets are constructed either in terms of services to be provided (outputs) or impacts to be achieved (desired outcomes). It is an attempt to frame planning, resource use and accounting, around the big choices which politicians need to make.

Moving to this type of budgeting requires a willingness on the part of Parliaments to relinquish some control over individual programs and ministries in exchange for more efficient service delivery and better performance. To be successful, top level managers need confidence that goals have been achieved, or more specifically that government data is accurate. This confidence, as in accrual accounting, must come from well institutionalised management controls verified by a trusted and independent audit process.

None of these important budgeting goals in support of better governance is achievable without related changes in the accounting system. It is the accounting system that converts policy and budget intent into financial management and control information. It is only with appropriate skills, motivation and systems of control, that these modern systems deliver their potential.

3. Conclusion

Traditional public administration is internationally widespread and has been durable, because the ideal of rules ensuring equal service delivery to every citizen has strong popular and political appeal. Moreover it is durable because traditional public administration can continue to operate where bureaucrats do not have highly specialised skills and where they may not be trusted to exercise discretion. The kind of changes we are talking about are crucially dependent on relatively specialised skills (*e.g.* the transition to and use of accrual accounting).

These new approaches will not work at either the political or the bureaucratic level in the absence of a supportive culture. It may not be possible for a government to leap frog to such reforms. Rather system changes should occur gradually as public officials internalise values and attitudes to the point where there is a supportive culture for rule compliant behaviour oriented to the public interest. It is only in such an atmosphere of relatively high trust and low enforcement costs, that the full advantages of high managerial discretion will be realised.

The work of the OECD is to promote stable and sound governance arrangements. The budget is a nation's, a province's or a city's most important policy document. Consequently, to promote sound governance arrangements, the Member countries of the OECD are committed to producing well-crafted budgeting and reporting systems that are tailored to the business of government. Budgets are constructed in a way that encourages politicians and public servants to act coherently in the larger public interest. This is achieved:

- vertically, by connecting policy intent to administrative action,

- horizontally, by ensuring that one action of government is consistent with another, and

- temporally, by recognising that sound governance includes care for the interests of future generations.

Conditions of separated decision-making, transparency and accountability help these processes to be self-cleansing over time and thus provide the insurance of a successful society in the long-run.

ANNEX
CHARACTERISTICS AND FUNCTIONS OF THE OECD

The Organisation for Economic Co-operation and Development (OECD) was founded in 1961, replacing the Organisation for European Economic Co-operation (OEEC) which had been established in 1948 in conjunction with the Marshall Plan. The OECD brings together 30 Member countries in a unique forum in which to discuss, develop and perfect economic and social policy. Members compare experiences, seek answers to common problems and work to co-ordinate domestic and international policies that increasingly in today's globalised world must form a web of even practice across nations. The characteristics and functions of the OECD are:

- It is an intergovernmental economic organisation, global (though not universal) in its membership, relying on sound and objective policy analysis, confidential dialogue and peer pressure between public officials to promote international co-operation and collaboration to improve public policy.

- It is "economic" in the broadest sense, OECD work mirroring most of the policy concerns of governments, with expertise in the full-range of economic, social and institutional issues, including governance itself.

- It has the capacity to reach beyond national governments to address public policy-makers at all levels and brings together all those who have an impact on policy-making.

- Its membership enjoys a high degree of homogeneity in that all Member countries are presumed to share common economic and democratic principles and respect for human rights.

- The global nature of membership ensures an Asian-Pacific/North American/European interaction across the full-range of economic/social issues available in no other forum, allowing the OECD to address "system frictions" on a global scale. This includes an increasing capability for interaction and dialogue with many non-members in all regions of the world.

- Its policy prescriptions are tested across many different disciplines in many countries, which enhances their credibility and broad acceptance.

- Close interaction between the Secretariat and national government is a hallmark of OECD work, which has permitted the successful application of a multidisciplinary approach to a host of complex issues.

For almost 40 years the Organisation has been one of the world's largest and most reliable sources of comparable statistical, economic and social data. The data received from governments are harmonised and rendered comparable to facilitate comparison and analysis. OECD databases span areas as diverse as national accounts, a range of economic indictors, the labour force, trade, employment, migration, education, energy, industry, taxation, tourism and the environment.

Source: *OECD Annual Report 2000*, p. 8.

NOTES

1. The characteristics and functions of the OECD are described in the Annex. Currently, OECD Member countries are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States. Since this Symposium took place, the Slovak Republic has become a Member country.

2. For more information on this topic, see Gruen, N. "Greater Independence for Fiscal Institutions", *OECD Journal on Budgeting*, Vol. 1 No. 1, 2001.

3. For more information on this topic, see Blöndal, J. "Budgeting for the Future", *OECD Journal on Budgeting*, Vol. 2 No. 2, forthcoming.

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN CHINA
BY
LOU JIWEI*

The active promotion of financial system reform centring on the government budget management system has been an important policy decision of the Chinese Communist Party Central Committee, the National People's Congress and the State Council. It also represents another major reform to the Chinese financial management system, following the implementation of the "tax allocation system" and the new taxation system. In recent years, under the correct leadership of the Party Central Committee, the National People's Congress and the State Council, and with the great support and co-operation from the various departments under the State Council, China's budget management system has made significant progress with notable effects. Relative to the traditional Chinese budget management system, the current budget management system reform amounts to "revolution". Currently, the reform process has entered a most critical phase, with major tasks to tackle and a long way to go.

1. Status of Chinese budget management system reform

At present, reform to the Chinese budget management system covers three substantive aspects. The first aspect entails primarily the preparation of department budgets – basic expenditure budgets, project budgets, along with changes to the classification of government revenues and expenditures. The second aspect concerns the adoption of a single treasury account for reforming the treasury management system. The third aspect involves pushing ahead with financial expenditure management reform measures, focusing on government procurement.

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1.1. Department budget reform

Background of department budget reform. The need for improving and standardising the preparation of the budget of the central government was noted in the "Audit Report on the Execution of the 1998 central [government] Budget and Other Financial Revenues and Expenditures" made by the National Audit Administration on behalf of the State Council at the 10th Session of the Standing Committee of the 9th National People's Congress in June 1999, and in the deliberations by the Standing Committee of the National People's Congress on the 1998 Central Government Budget and the central government financial audit report. The major opinions and requirements suggested by the State Audit Administration and the Standing Committee of the National People's Congress expressed several viewpoints and made the following requirements: (1) "strictly execute the Budget Law and provide timely budgetary approvals"; (2) "provide details in the contents of the draft budget submitted to the National People's Congress for examination and approval, and increase transparency"; (3) "the contents [of the budget submission] should be augmented by [information about] expenditures of various central [government] departments, expenditures the central government subsidising local governments, and expenditures of key projects". The Budget Affairs Commission under the National People's Congress (NPC) specifically required data on revenues and expenditures of various central government departments and department budgets in the Fiscal Year 2000 national and central government draft budget submitted by the Ministry of Finance to the Congress. The Ministry of Finance, after earnestly studying these requirements of the National People's Congress, resolved to substantially improve budget preparation and to actively and steadily advance the reform of China's budget management system.

The importance and necessity of department budget reform. The department budget reform is important for several reasons. It helps to increase uniformity in budget preparation, and enhance the authoritativeness of the budget. It helps to standardise budget management, and provide details in the budget document.

Implementing department budgets facilitates uniform budget preparation. The traditional Chinese budget preparation methods are no longer appropriate for the system of socialist market economy. For example, in the past the organisational structure in the Ministry of Finance was designed to match the management of a planned economy. Each operating department of the ministry was in charge of several categories of expenditures by function, making it necessary for the various central government departments to establish contacts with virtually all of them. As another example, some budgetary resources are allocated by the State Planning Commission, the State Economic and Trade Commission and the State Council Administrative Bureau. All these organisations had their own work styles and management methods, making it impossible to avoid inconsistency in timing, as well as lack of uniformity and standardisation in form and contents in budget preparation, and in the release of budgetary resources. This not only adversely affected the authoritativeness of the central government budget, but even more seriously hindered the strict execution of the budget by the various departments and units, and hampered improved utilisation of resources. Departmental budgeting is intended to achieve the goals of openness, fairness and equity in managing financial resources. The realisation of these goals necessitates increased emphasis in uniformity and standardisation in organisation and in methodology. In this regard, the Budget Department [in the Ministry of Finance] has been designated as the sole point of contact for purposes of receiving [budget requests] and granting department budget approvals in a unified manner. Also uniform departmental budget forms and computer operating software have been designed. Uniform regulations have also been promulgated regarding the specification and transmission of department budgets, the timetable for budget preparation and release of budgetary resources, as well as departmental responsibilities. Since a department's revenues and expenditures are all reflected in one budget book, central government departments for the first time have a complete budget. It covers both the revenues and expenditure of: *i)* the general budget; *ii)* central government funds; and *iii)* extra-budgetary funds. Furthermore, a departmental budget reflects appropriations managed directly by the financial department, as well as the funds made available through departments with the budget granting power, such as the State Planning Commission, the State Council Administrative Bureau, and the Ministry of Science and Technology.

Implementing departmental budget affirms the authoritativeness of the budget. The Budget Law requires the Ministry of Finance to give central government departments budget notifications within 30 days upon the NPC's approval of the central government budget. These departments should in turn give budget notifications to their subsidiary units within 15 days of the approval by the Ministry of Finance. However, budget notifications were given at different times and did not always meet the required due dates. The practice resulted in part from the variations in time schedules and requirements for reasons described earlier. This situation undermined the authority of the Budget Law and adversely affected the functioning and effective utilisation of funds by the departments concerned due to the uncertain timing of the release of budgets. After the trial period for the Fiscal Year 2000 departmental budgets, the departmental budgets of more than 150 central government budget units were all approved by the Ministry of Finance and reached them within one month upon NPC approval of the central government's draft budget. This was inconceivable in the past. Moreover, these budgets covered all the revenues and expenditures of each department. Things that could not be done by itemised expenditure management are now feasible, thanks to the innovations introduced by departmental budgeting.

Implementing departmental budgets is helpful to the standardisation of budget management. Traditionally, the annual expenditure budgeting used the so-called "base number method." The actual expenditure amounts of the preceding year were used as the base, which would then be adjusted by a growth factor. Consideration would also be given to the national economic and social development plan for the following year, and the availability of financial revenues and various factors that might affect expenditures. Different expenditure categories would be assigned a different percentage growth rate. The irrationality in the base amounts caused uneven resource distribution among departments and among expenditure categories. Using this as a justification, departments would often unilaterally alter the use of funds in contrast to budgetary stipulations. As the financial departments themselves did not have a sound basis for the initial allocation, they felt a lack of justification to compel conformance. Consequently, some departments hardly had funds to make ends meet, while others had surplus resources to use for unspecified purposes. Under the department budgeting system, all the revenues and expenditures of a department would be reflected in one master budget, making it possible for the scientific and rational examination of various expenditure requests. This is quite a departure from the past when attention was confined to the base amounts. Under such a system, we were unable to squarely face the demand for resources and prepare a comprehensive plan on the basis of scientific and rational allocation of financial resources. The preparation of department budgets have motivated all the budget units and financial departments to examine the various revenues and the financial resources needed to carry out a department's official duties. The new system has enabled us to scientifically and rationally balance subsistence needs and capital investments for development purposes. It is also necessary to equitably allocate funds for personnel expenditures and other public expenditures, so that we can develop the national economy to meet the needs of various priority expenditures and realise the policy goals of the macro-economic development.

Implementing departmental budgets facilitates the preparation of detailed budgets. Traditionally budget allocations in China were made in terms of expenditure functions. In view of the unclear delineation of budget categories and the lack of details about the contents of various expenditures, not only would the layman fail to understand it, but even the experts could only see the trees and not the forest. Moreover, for many years, the central government budget covered only in-budget funds, leaving out off-budget funds, various other government funds and public service revenues to the discretion of the units themselves. This easily led to various kinds of corruption. Preparing departmental budgets has provided a standardised management model for all the units, and allows them to fix all their revenues and expenditures in a form of a legally adopted budget. On the basis of the revenues in the past years and estimates of increases or decreases in the following year, departments project their own revenues by item and by organisational unit. Similarly, expenditure requirements are projected on the basis of a department's personnel expenditures and other public expenditures. These demands are evaluated in terms of urgency and priority, taking into account all the relevant considerations in the budget year. Resources are made available to fund special items such as capital construction, developmental innovations, and science and technology. Support is also provided – on the basis of full project evaluations – for agricultural production, and special public services, such as education, science, health, culture, sports and broadcasting. This approach thus enables the departments to classify and prioritise the various expenditures in line with the national economic and social development plan. They can gradually formulate rolling project plans for funding specific projects.

Departmental budget preparation in the last two years. In August 1999, the Ministry of Finance initiated joint studies to come up with reform plans for improving and detailing the Fiscal Year 2000 central government budget. The ministry invited the organisations which possess budget allocation authority, *i.e.* the State Planning Commission, the State Economic and Trade Commission, the State Council Administrative Bureau, and the Ministry of Science and Technology. These were joined by 11 central government departments with expenditure authority, including the Ministries of Education, Agriculture, Social Security, Health and Culture. On the basis of fully incorporating the views from these parties, the Ministry of Finance formally submitted to the State Council a document entitled "Views Regarding Improving Fiscal Year 2000 Central [Government] Budget Preparation". On 20 September 1999, the Ministry of Finance issued Finance & Economic Circular No. 1999/464 "Notice Regarding Improving Fiscal Year 200 Central [Government] Budget Preparation". The circular formally required all central government departments to prepare department budgets in accordance with the requirements of the State Council.

In order to ensure the smooth operation of preparing department budgets, the Ministry of Finance convened a meeting of finance directors of all Level 1 central government budget units. A uniform timetable was proposed for the various stages of departmental budget preparation. All the departments were required to prepare and submit their department budgets according to this uniform timetable. The proposed budget amounts submitted by the various

Level 1 budget units were examined on a timely basis by the various operating departments in the Ministry of Finance in close co-operation with departments with budget allocation authority. The examination results formed the basis of a draft central government summary budget submitted by the Ministry of Finance to the State Council for approval. Following the approval, in late November the Ministry of Finance issued budget control amounts to the various budget units.

The budget units modified their budget requests in light of the budget control amounts given by the Ministry of Finance and submitted their departmental budget amounts to the Ministry of Finance by 25 December. The Ministry of Finance then prepared a central government draft budget by function and transmitted it, along with the department budgets of the four pilot ministries (Education, Agriculture, Science and Technology, and Social Security), to the State Council. There followed several exchanges of views with the Budget Affairs Commission of the National People's Congress. At the end of February 2000, on behalf of the State Council, the Ministry of Finance formally submitted to the National People's Congress the Fiscal Year 2000 central government draft budget and the department budgets of the four pilot ministries. On 15 March 2000, the National People's Congress formally approved the central government draft budget. Afterwards, the Ministry of Finance provided budget notifications to each Level 1 budget unit within the one-month time limit provided for by the Budget Law.

Building on the experience form the Fiscal Year 2000, the initial list of four pilot ministries selected for department budget preparation was expanded to 26 ministries under the State Council. The contents and form of the reports were improved. The department budgets reflected both the overall outlook of the department budgets of the 26 ministries and also showed the different characteristics and situations of each ministry. They included both the appropriations funded by central government revenues, as well as extra-budgetary funds, governmental funds and expenditures funded by revenues raised by the units themselves. Currently [April 2001], the Ministry of Finance is in the process of notifying the central government ministries of their budgets, following the NPC's approval of the Fiscal Year 2001 central government budget.

Remaining issues with department budget reform. At least three issues remain to be resolved: standards for determining budget base, the evaluation mechanism for earmarked projects, and budget classification.

No expenditure standards and budget quota have been scientifically established. The "base number method" was used in preparing the Fiscal Year 2000 central government department budgets. It is well-known that budgetary base is determined through a long historical process of accretion. Over time, government units experience varying changes in terms of the number of personnel, and mission and scope. The new situation should have led to a funding level different from the base amount predicted on an old set of circumstances. However, due to system inertia, this kind of "base amount" has acquired considerable rigidity. It is not only difficult for a department to change it to accommodate the actual situation; it is also impossible for the financial departments to make overall adjustments. When the "base quota" varies considerably from the actual resource requirements, the resulting budgets would inevitably lead to uneven levels of assured funding support among departments. This obviously contradicts the principles of public finance. It is also inconsistent with the requirement that government departments provide an equitable level of service to the general public. Even if some expenditure categories have basic expenditure quotas, the validity of such quotas suffers from excessively broad categorisation and the lack of scientific rationale. There does not yet exist a comprehensive quota system covering all current expenditures. Besides, expenditures financed out of departmental revenues are not included in the financial expenditure quota. Due to the lack of a scientific and rational budget quota system and the support of relevant data, the preparation of the Fiscal Year 2000 central government department budgets still remained at a preliminary stage. In 2001, the Ministry of Finance is using the "basic expenditure budget" and "project budget" approach to prepare the department budgets of only 10 central government departments, including the State Planning Commission and the Ministry of Foreign Trade and Economic Co-operation. Despite the effects attained in these cases, much work remains in applying this approach to all the departments.

No comprehensive and scientific evaluation mechanisms have been established for the budget of special project funds. There exist certain funds created for specific projects with developmental goals.[1] The traditional budgeting procedure for these projects calls for securing their overall expenditure budgets, then these budgets are assigned to specific projects. That is, the finance department would first divide blocks of funds; departments that manage these funds would then allocate these funds to projects and budget execution units. In the Fiscal Year 2000, due to a tight timeframe and the lack of favourable conditions, project budget preparation still used the old method. Standardised methods were not used to examine and fund projects, and department budgets did not assign funds down to specific units and projects. This was detrimental to the timely execution of project budgets and to the authoritativeness of the budget.

Matching reform measures have not caught up. The old budget account classification system, even though it is not scientific, is still in use. In it departmental classification overlaps with the functional classification, and various economic activities cannot be accurately reflected. Department budget preparation is not organically linked with government procurement. The centralised treasury collection and payment system is not implemented. There is room for improvement in the design of report forms and software. From a management perspective, the institutional arrangement of various departments (including the Ministry of Finance) has not adapted to the needs of departmental budgeting. In addition, some units do not pay enough attention to their departmental budget preparation, as evidenced by the lack of conformity of some forms submitted by some units and the failure to adhere to the uniform timetable. To some extent many issues can be expected to emerge in a new process such as departmental budgeting. They are awaiting resolution in the future.

Directions for improving department budget preparation. The guiding spirit for further improvement in department budget reform is: "Reaffirm targets; be proactive and steady; adequately experiment; and implement in stages". Regardless of great difficulties and risks, we shall remain committed to budget reform and steadfastly advance toward the goals. During the reform process, while we adopt a proactive attitude toward innovation, budget reform proposals should be meticulously justified. Preparatory work should be done well in order to resolve contradictions and overcome resistance. Pilot experiments should precede full-scale implementation. Problems are analysed in practice, experiences are accumulated, and plans are improved. From this year onward, budget preparation reform will gradually advance by steps and stages, so as to achieve full implementation nation-wide within three to five years according to the goals of budget reforms and requirements.

There are mainly three tasks to improve department budgeting: *i)* scientifically classify government revenues and expenditures; *ii)* use budget quota to manage the basic expenditure budget; and *iii)* establish an evaluation system and a projects databank for project expenditure budgeting, and implement rolling budgets for projects.

The goal of reforming government revenue and expenditure classification is to establish a new system that accurately reflects the functions of the government, the directions of revenues and expenditures, and the economic nature of various revenues and expenditures. It consists of departmental classification, functional classification and economic nature classification. These three parts, while independent, also complement one another. The goals for the 2001 phase are: *i)* revise and provide additional details for expenditure items; *ii)* revise the apparently inapplicable and irrational titles sub-categories of revenues; and *iii)* issue “Government Budget Revenue and Expenditure Account Classification Manual, Fiscal Year 2002”. At the same time, the reform plan for revising the government revenue and expenditure classification will be studied further, with the view of nation-wide implementation when conditions are favourable.

The various current expenditures in administrative units and public service institutions can in fact be divided into two parts: basic expenditures and project expenditures. There already exists the foundation for implementing the budget quota system for basic expenditure of the same economic nature in similar units. After first securing the basic expenditure budget of a unit, the financial department should fund project budgets in accordance with financial capacity and the principle of “do as much as you can afford.” Another step is to establish an evaluation system and a project databank. Upon examination and evaluation, the projects shall be ordered in terms of importance and urgency. The current year’s project budget would then be determined for priority projects.

The goal of basic expenditure budget reform is to be achieved in two stages. In the first stage, a system of “fixed staffing and fixed budget quota” would be completely implemented in central government administrative units and in public service units using the state civil servant system. The implementation would be carried out steadily so as not to materially affect the current financial strength of the various units. Another aspect of implementation is to make the standard for setting budget quota transparent. In the second stage, other public service units would be classified for the purpose of applying different budget preparation methods. Measures for standardisation would be formulated for preparing the basic expenditure budgets of public service units. Pilot experiments would be conducted at select public service units of certain types. Then, with he exception of very few special types of public service units, the “fixed staffing and fixed budget quota” of determining basic expenditure budgets would be implemented on a full scale.

The goal of project expenditure budget reform is to implement standardised project expenditure budget management in all central government administrative units, public service units using the state civil servant system, and public service units that implement the “fixed staffing and fixed budget quota” system on a trial basis. For those central government public service units that do not implement basic expenditure budget reform for the time being, the Ministry of Finance will select some units to implement standardised project expenditure budget management, while other units need to establish candidate project banks on their own according to the requirements of project expenditure budget management. Project expenditures administered by the State Planning Commission, the State Economic and Trade Commission and the Ministry of Science and Technology (such as capital construction expenditure, enterprise developmental innovation funds, and science and technology expenditures) shall have management measures formulated by the departments according to the uniform requirements of the Ministry of Finance. In line with the uniform requirements by the ministry, these should be brought into the department project databank for management. Then, on the basis of learning from experiences, project expenditure budget management will be completely implemented in all central government administrative public service units.

1.2. Treasury management system reform

Background to Treasury management system reform. Since the beginning of [economic] reform and opening-up, a series of major reforms have been made to China's financial and tax system. In particular, tremendous achievements have been scored by the financial and tax system reform of 1994. However, for various reasons, reforms in the past mainly centred on adjusting the [resource] distribution relationships [between the central government and lower-level governments] and basically did not touch on the budget management system or the remission and disbursements of funds. The Treasury management methods predicated on the traditional system could no longer respond to the development requirements on public finance under the system of socialist market economy. Its exposed shortcomings have become increasingly glaring. These include mainly: the duplication and wide dispersion of accounts; delays in feedback of information about revenues and expenditures; operational inefficiency and ineffective use of funds; frequent detention, diversion and unauthorised use of funds; and monetary inducements for corruption. In order to solve these problems in revenue and expenditure management, the Chinese Government has decided to seek solutions in terms of system, mechanism and the origin [of funds]. In recent years, the Ministry of Finance has instituted financial payment system reform measures in certain areas. These include: unified payment of wages by finance offices in administrative units; direct appropriations for some central grain warehouse construction funds and for vehicle purchase tax special transport funds. Some regions have also made similar reform pilot experiments, such as "centralised accounting" and "overall management of minor accounts". Though labelled differently, they have had some notable effects.

Basic principles of Treasury management system reform. In designing the reform proposals, the Ministry of Finance has fully consulted successful international experiences. These proposals have to be responsive to the development needs of public finance under a socialist market economic system, and securely rooted in China's specific circumstances. The Treasury management system is built on the basis of a single Treasury account system, and uses centralised treasury collection and disbursement for the remission and appropriation of funds. The reform principles we have specified require the system to facilitate:

(1) *Operational standardisation*. The system has to properly determine the respective management responsibilities of the financial departments, tax collection units, budget units, state Treasury at the People's Bank of China, and agency banks. It should not alter the budget units' authority over the use of funds. It should bring all the financial receipts and expenditures into the single Treasury account system according to standardised procedures.

(2) *Management supervision*. The system should strengthen the transparency of activities affecting financial revenues and expenditures. It basically does not modify the budget units' financial management and accounting. The main objective is to bring the whole process of revenue remittance into the Treasury and disbursements of appropriations under effective supervision and management.

(3) *Expeditious use of funds*. The system seeks to reduce the number of steps in applying for funds and in the steps of disbursing appropriations, thus facilitating the timely and convenient use of funds by the budget units.

(4) *Gradual implementation in stages.* The reform proposals should be systematic and forward-looking in nature, making it possible to gradually realise the reform goals.

Main substance of Treasury management system reform. In keeping with the above principles, China's Treasury management system reform has incorporated the following features: a single Treasury account system, standardised revenue collection and expenditure disbursement procedures, and matching measures.

A single Treasury account system. Currently, financial departments set up Treasury accounts and special financial accounts (for extra-budgetary funds) in the central bank and commercial banks. The budget units individually open accounts in commercial banks for handling deposits and payments and for accounting for financial resources. It is a highly dispersed arrangement. After the new financial Treasury management system is implemented, the practice of budget units opening accounts on their own will be changed. Various accounts will be set up by finance departments within the single Treasury account system in a uniform manner as follows: *i)* financial departments will open a single Treasury account in the Central Bank for use in accounting for revenues and expenditures within the budget; *ii)* financial departments will set up "financial zero balance" accounts and "budget unit zero balance" accounts in commercial banks for use in making payments and clearance of financial funds: *iii)* financial departments will open special financial accounts for extra-budgetary funds for use in accounting for extra-budgetary revenues and expenditure; *iv)* financial departments will set up "petty cash accounts" for budget units for their convenient use in making small expenditures; *v)* upon approval by the State Council, the financial departments will open special transitional accounts in commercial banks for budget units to accounting for special expenditures.

Standardising the procedure of revenue collection and payment. Presently there are three ways of paying into the Treasury: local payment, centralised payment and self-collection summary payment. These will be streamlined and grouped under two methods: direct payment to the Treasury and centralised summary payment. In the direct method, the payer (or his agent) files a payment declaration; after the collector's examination and certification of no errors, funds are directly transferred from the payer's bank account into the single Treasury account or special financial accounts. In the centralised summary payment method, the collector gathers all the revenues and remits them into the single Treasury account or special financial accounts. After the new system is completed, standardised remittance to the Treasury will be implemented for all in-budget or extra-budget funds. And the current practice of payment of some revenues into the Treasury by way of transitional accounts will be abolished.

Standardising the procedure of expenditure disbursement. The new way of expenditure disbursement has distinctive procedures for wage payments, purchase payments, petty payments and transfer payments. These payments are made directly by the finance departments or by its delegation to the budget units. Under the direct method, a financial department issues payment orders to agency banks; funds are transferred from the single Treasury account system to the bank account of the recipient or the unit authorised to spend the funds. This method is used in making wage payments, transfer payments and some purchases. In the delegation method, a finance department would have to authorise a budget unit to make payments. The budget unit would then issue payment orders on their own and make funds available to the recipient through the single Treasury account system. The second method is intended for small amounts and some purchases. Upon full implementation, the direct method will be the main mechanism for making payments. No longer will it be necessary for the finance departments to transfer funds to the departments for further disbursements down the line, thus eliminating many of the problems noted earlier.

Relevant matching measurers. Implementing financial Treasury management system reform involves complicated systems engineering, requiring the support of matching measures. These mainly include: *i)* further improvement in the methods of budget preparation, *i.e.* providing additional details in the budget and pushing ahead with department budgets; *ii)* revising the Budget Law and its related rules and regulations, such as "Measurers for Managing the Payment of Financial Funds", in order to provide the necessary legal basis for the reform; *iii)* establishing financial management information systems and improving modern bank clearance systems, thus assuring reform with the necessary technological means; *iv)* setting up Treasury payment execution institutions to specifically engage in such operations as funds disbursement, accounting, supervision and inspection, and providing the reforms with organisational guarantee; and *v)* strengthening supervision and enforcement mechanisms, in order to ensure security and efficiency in the process of disbursing financial resources.

Basic concepts for implementing experimentation. Recently, the State Council approved the "Plan for Financial Treasury Management System Reform" jointly submitted by the Ministry of Finance and the People's Bank of China. A decision was made to carry out financial Treasury management system reform pilot experiments in several central government ministries and commissions, and in some provinces. In order to ensure their advancement, the Ministry of Finance has adopted a proactive and prudent attitude, and stress the following aspects in the design of the reform proposal:

As much as possible is done to achieve uniform management of accounts, and strive toward the direction of establishing a single Treasury account. Finance departments would be the ones to set up a unit's financial funds accounts. The accounts of administrative units and public service units would be cleared and inspected. All existing accounts (including those belonging to level-one units and level-two units) would either be cancelled or combined and be gradually brought into a single account system.

The scope of direct payments and delegated payments would be properly determined. In the interest of efficient operations, the direct payment method is contemplated for use in large- and medium-scale construction projects, government procurements and personnel compensation. Budget units are authorised to payments for other frequent and regular expenditures. The

Ministry of Finance in consultation with various departments will determine the precise scope and formulate specific operational measures.

After department budgets are finalised, in accordance with the division of the scope of direct payments and delegated payments, the budget indicators of the budget units' direct payments and delegated payments are checked and ratified. For delegated payments, a budget unit's monthly amounts are determined after the monthly payment schedules are examined and approved. Subject to the specified limits, the budget units can make payments on their own. The State Treasury Department of the Ministry of Finance, giving due consideration to the financial status of the Treasury, will release funds as long as the requests are deemed reasonable.

In the case of direct payments made by finance departments, every effort will be made to give payments directly to providers of goods and services themselves. Otherwise, payments will be made to organisational units [for subsequent transmission to the providers of goods and services].

In the case of delegated payments, budget units can issue payment orders, establish a system of financial records, and transmit, via computerised information management systems, timely payment information to the Treasury department. The Treasury will record the payments in the accounts, and ascertain whether payments were supported by a budget and financial plan. In the absence of errors, funds would be released. In other words, the finance department only checks for compliance with regulations, while the operating departments themselves are responsible for the justifiability of spending.

The Treasury management system reform does not change the budget units' financial management and accounting authority. The responsibility for budget execution rests with the budget units themselves. Even after the change in the methods of payment management, budget units still need to strengthen financial management and accounting, such as forwarding receipts, bookkeeping and record maintenance. Finance departments will control only the expenditure indicators; various departments and units are still responsible for budget execution. Whether it is direct payments or delegated payments, operational procedures rest with the various departments and units.

We are contemplating 1 July this year [2001] as the starting date for experimentation in several central government departments. Provinces and local governments may decide on their own the time and steps for the experiments according to local circumstances. On the basis of such experiences, the scope of the reform experimentation would be further expanded in 2002. The reform proposal would be further improved in the process. We endeavour to comprehensively implement a modern state Treasury management system during the "Tenth Five Year Plan" period – a system that is based on a single Treasury account system and uses centralised state treasury for making collections and payments.

1.3. Government procurement reform

Encouraging progress. Implementing and promoting the government procurement system is a requirement for establishing a socialist market economy and a related public finance system framework. It is one important aspect of strengthening financial expenditure management. For China, government procurement, though relatively new and starting rather late, has progressed quite rapidly. After several years' efforts, a rather comprehensive system for managing government procurement – in terms of basic system development, management structure, means of procurement, financial resource management, supervision and inspection – has achieved some notable effects. Nation-wide [government] procurement expanded from 3.1 billion Yuan in 1998 to around 30 billion Yuan in 2000. Currently, the work of government procurement is proceeding from the stage of initial establishment to comprehensive implementation.

A framework of principles for regulating government procurement has basically been formed. In conformity with the relevant provisions of the Budget Law, the Ministry of Finance in 1999 successively promulgated "Interim Measures for Government Procurement Management," "Interim Measures for Management of Bidding and Tendering for Government Procurement," and "Interim Measures for Supervision of Government Procurement Contracts." These measures contain clear requirements concerning: the scope of government procurement, management institutions, models of procurement, procurement budget preparation, bidding and tendering procedure, contracting, appropriation and payment of funds and procurement oversight. They also provided, in principle, the conditions and procedure for agents to gain access into the government procurement market, contractual performance, acceptance inspections, separate listing in the budget and the forms of payment. The year 2000 saw additional efforts devoted to the construction of a legal framework for government procurement. The government formulated and promulgated the following rules and regulations: "Measures for Managing Public Dissemination of Government Procurement Information", "Notice on Strengthening the Work of Preparing Statistical Reports on Government Procurement Data", "Temporary Regulations on Government Procurement Process" and "Catalogue of Government Procurement Goods". These measures have preliminarily standardised the work on government procurement management in these areas:

uniformity in the release and management of information about government procurement; enhanced openness and transparency of the procurement process; standard operating procedures; greater clarity in the responsibilities of government procurement executive institutions and intermediary agency institutions. They further implement the requirement for separating regulators and implementers made by the Central Disciplinary Inspection Committee. They clarified the scope of government procurement, and provided a uniform basis for finance departments and budget preparation units at all levels to prepare government procurement budgets and for the catalogue of centralised procurement.

On the basis of the above provisions, most regions around the country have adopted corresponding measures. These measures signify that preliminary formation of a regulation system for promoting government procurement exist. They also provide the systems guarantee for the rule of law in carrying out procurement activities.

*The procurement work of local governments is in full implementation***.** The pilot government procurement work in China started in Shanghai in 1996. In 1999, finance departments in various regions generally increased the scale of implementing the government procurement system in accordance with the provisions of the relevant systems promulgated by the Ministry of Finance. Government procurement management institutions continue to improve and the volume of procurement is expanding gradually. Preliminary reports indicate that in 2000 the financial departments in all the provinces (including autonomous regions and municipalities under the jurisdiction of the central government) had structures for managing government procurement. They have also started government procurement on the basis of separating oversight and execution functions. Also, in quite a number of provinces, the finance departments in prefectures, cities and counties have also set up institutions and undertook government procurement work. Thus the volume of procurement scale further expanded.

The government procurement work of central government's national institutions has gradually started. In 2000, the government procurement of these organisations was approximately 3 billion Yuan, representing an increase of 50% over that in 1999. About 1.2 billion Yuan of this amount was accounted for by the State Council Administrative Bureau. The Customs Office successively organised a number of tendering activities for engines, shipbuilding, automobiles and assembly projects. The Ministry of Civil Affairs also tendered procurement for tents used in disaster relief. The Ministry of Health and the State Administration of Traditional Chinese Medicine also procured women and child healthcare equipment through public tendering.

The government procurement budget system has been gradually established. Budgeting for government procurement is the foundation for this activity; it is also a precondition for standardising government procurement and strengthening its planning. In the past few years, various units have generally compared government procurement plans. In particular, beginning in 1999, the central government has taken the lead in incorporating government procurement plans into department budgets in connection with reforming departmental budgeting. This step, in combination with detailed departmental budgets, greatly facilitates operations and supervision. This year, various regions will similarly bring their government procurement plans into departmental budgets. All of these actions have contributed to the further development of budget management of government procurement activities.

Major issues with the current government procurement system. China's government procurement system faces several issues that will require resolution in the future.

Government procurement is still small in scale and narrow in scope. International experiences show that the level of government procurement in a country is generally more than 10% of its GDP, or about 30% of its [government] expenditure. Calculated by the former measure, the government procurement scale in China should be more than 800 billion Yuan; by the latter measure, it should be around 400 billion Yuan. There is a sizeable discrepancy between these two measures of government procurement. The main reason is that the percentage of China's [government] revenues relative to its GDP is relatively low. In 2000, local governments in China procured only around 11 billion Yuan in goods and services, while number for the central government was less than 3 billion Yuan, accounting for 4% of GDP. This situation shows that work for government procurement is just beginning in China, with a great deal of standardisation to do.

The level of professionalism of the personnel government procurement is not high. Government procurement requires knowledge of multiple disciplines such as economic science and natural sciences. Managers not only need to be familiar with finance and management, they also require knowledge and skills in such diverse areas as biding and tendering, contract management, and functionality of products. Currently, in most government organisations, public service units and civic associations – particularly those at the grass-root level – do not have enough managers and professionals familiar with common international practices in procurement. Irregularities [therefore] frequently occur in procurement activities.

Government procurement is not sufficiently planned. As department budgets currently being experimented are not sufficiently detailed, it is hard to prepare uniform and complete procurements budget and plans. In executing the annual budget, there are frequent unplanned purchases. This results in small volumes in each purchase, higher transaction costs and lower efficiency. All of these have detrimental effects on economies of scale and overall effectiveness of government procurement.

There does not exist uniform operational procedures for government procurement. When the scope expands and the work becomes more intensive, many specific operational procedures and technical problems are encountered. These include public dissemination of information, fund management and disbursement, modes of contracting, handling of breach of contract, acceptance inspection and handling of complaints. Currently there is still a lack of uniformity and standardisation in these areas.

In both central and local government procurement activities, there have been instances of market partitioning and discrimination against suppliers. By means of regional blockade and [government] department monopoly, some local governments actively discourage other suppliers' participation in the bidding process. Several major reasons explain the restraints on the further development of the government procurement. First, China does not have a sound legal framework in this field. It has not yet promulgated a government procurement law. There are only department rules and regulations, and their binding effect is not sufficiently strong. Second, old concepts have not changed. Government procurement involves the readjustments of vested interests. Some departments and industries retain the sentiment of resistance and do not show active involvement in this matter. Third, a complete set of complementary reform measures have not been adopted. Detailed budgets are a precondition for undertaking the government procurement work, while a centralised Treasury payment system is necessary for assuring its success. Even though the Ministry of Finance is currently actively implementing in these two reform measures, they are a time-consuming process. When the items subject to procurement are not clearly identified, the scale and scope of government procurement is restricted. The absence of a centralised Treasury payment system undermines the ability to push forward the government procurement system. In addition, some departments and industries have adopted certain standards for compliance inspection checks, and have designated particular brands and suppliers. All of these steps have adversely affected the pace of government procurement in some cases.

Basic proposals for reform. In order to gradually realise the development goals of the government procurement system, our plan is to effect the transition from a initial attempt to comprehensive promotion in two to three years, beginning next year, by taking the following steps: *i)* further improve the various rules and regulations for government procurement; *ii)* expand the procurement scale and scope, bringing all the procurement activities of state entities, public service units (subject to budget management) and civic associations under the purview of financial supervision; *iii)* establish a standardised payment system for government procurements; *iv)* set up a sound information management system that integrates newspapers, magazines and networks; *v)* preliminarily establish a market access system for intermediary agencies and conduct research on and formulate market access methods for suppliers; *vi)* improve management and execution institutions, and develop a high calibre professional team.

To achieve the above transformation, and gradually establish a scientific and standardised government procurement system, we are prepared to:

Expand the scale and scope of government procurement. This requires the careful preparation of government procurement budgets and plans, and increasing the amount of government procurement expenditures as a percentage of financial expenditures and of department expenditures.

Establish a direct payment system for government procurement. Direct payment to vendors is the prevailing international practice. It also conforms the development requirements of a single Treasury account system. Therefore, the Ministry of Finance and the People's Bank of China have formulated and issued "Measures for Managing Direct Payments for Government Procurement". At the same time, we intend to strengthen the supervision and management of unorganised purchases, and promote the active trial use of government procurement cards in making payments.

Strengthen the basic management of government procurement. When problems arise in the procurement process, timely measures are to be taken to continually improve and strengthen capacity building.

Strengthen the legal framework. In early 1998, the "Government Procurement Law" was formally added to the legislative agenda of the National People's Congress. It is anticipated that the law will be deliberated and passed by the Standing Committee of the National People's Congress in 2002. Therefore, we need to do the relevant legislative research on the basis of the development needs of government procurement. Emphasis should be placed on formulating market access qualifications of intermediary agencies and suppliers, and requirements for the procedures of accepting and handling government procurement complaints. At the same time, it is necessary to enact provisions for the financial management of government procurement centres, and adopt a code of conduct for government procurement personnel.

Create publicity and train personnel. It is necessary to establish and improve the main channels for publicising government procurement. Intensifying the training government procurement personnel, particularly those at the prefecture, city and county level, is essential for continually improving their work-related qualities.

2. Basic status of Chinese Government budget accounting reform

2.1. A brief review of Chinese Government budget accounting reform

China's accounting systems have always been classified into two major categories in terms of what is being accounted for and the regulatory framework. Enterprise accounting, used in profit-seeking business operations, has a core concern for capital circulation and is based substantively on cost determination. Budget accounting, on the other hand, has a management orientation and aims at promoting economic and social institutional development. Its core function is related to executing the government's financial budget, and it is applicable to governments at all levels, administrative units and all kinds of public service units. It usually does not undertake complete cost accounting. More specifically, government budget accounting may be further divided into three major types: general budget accounting for state finances, administrative unit accounting, and public service unit accounting. It also encompasses Treasury accounting and accounting for revenue collection, which are both related to budget execution.

Since the 1980s, China's economic system reform has continued to intensify in the direction of a socialist market economy. This created certain demands for the budget accounting functions. To meet these developmental demands, China has instituted a series of reforms to improve its budget accounting system.

Revision of "General Budget Accounting System". In 1984 and 1988, the Ministry of Finance revised twice the general budget accounting system for state finances. These revisions sought to clarify and specify its tasks, define its organisational and management functions, build up its organisational structure, expand its purview, and regulate finance departments' accounts at the central bank's state Treasury. At the same time, some local governments, taking their regional characteristics into account, similarly revised "Local Budget Accounting Systems" and those for villages and townships.

Revision of administrative and public service unit accounting systems. By revising the system in existence since 1966, the Ministry of Finance promulgated a new "Administrative and Public Service Unit Accounting System" in 1988 for nation-wide implementation in 1989. This new system has mainly expanded its scope of applicability and extends the former unit accounting system (designed for total amount budget management, and overall revenues and expenditures) into a system adapted for three budget management approaches, namely: total amount, differential amount, and independent revenues and expenditures. Concurrently, three separate yet uniform charts of accounts were designed, thereby enhancing the substance of the accounts and rigorous management. Departments under the State Council that are affected adapted the system for their particular functions in light of their unique characteristics.

Revision of the Treasury management system. The "Provisions for the Central Treasury" enacted in 1950 was thoroughly revised and promulgated as the new "Provisions for the State Treasury of the People's Republic of China". Released in July 1985, these provisions comprehensively and systematically dealt with such issues of principle as the nature, role, jurisdiction and organisational structure of the national Treasury.

Comprehensive reform of the government budget accounting system. Entering the decade of the 1990s and in the context of needed reform for all accounting systems in China, the Ministry of Finance set up a leadership group for budget accounting reform and appointed an expert group to undertake a comprehensive revision of the budget accounting system. They produced "The Key Points of Budget Accounting System Reform" in February 1996. The document specified and explained the guiding philosophy, goals of reform, the accounting system, measurement methods and steps in the reform process. In May and July 1997, the Ministry of Finance separately released for implementation in 1998 the following documents: "Public Service Unit Accounting Standards", "Public Service Unit Accounting System", "Administrative Unit Accounting System", "Administrative Accounting System" and "General Budget Accounting System for State Finances". These documents contain comprehensive revisions to the accounting methods and account classifications in budget accounting. While they took into consideration international norms, these changes were made mainly in the context of China's current circumstances. Their aim was to form, though in a preliminary fashion, a single government budget accounting framework that integrates the three independent branches, namely, general budget accounting system, administrative unit accounting system, and the public service accounting system.

2.2. Basic characteristics of the current system

The government budget accounting system reform in 1998 started from actual circumstances of the objects of budget accounting. It was built on the inheritance of accumulated experience of effective accounting and management over many years. It also absorbed the successful experience of enterprise accounting reforms and made reference to international public sector accounting practices. The goal of reform was to initiate the establishment of scientific and standardised management models and operating mechanisms for budget accounting. Compared with traditional system, the new one has the following features:

Expanded scope of applicable hierarchy. The scope of applicability of the general budget accounting system for state finances has been expanded to the finances of village and township governments. There are now five levels in the general budget accounting system.

Strengthened management function. In the accounting and management of funds, the distinctions of total amounts, differential amounts, and independent revenues and expenditures are now abolished. They are replaced by uniform management and accounting for various financial resources managed by the finance departments.

General principles for accounting. These principles are: truthfulness, relevance, comparability, uniformity, consistency, timeliness, and clarity. The principle of "special funds for special purposes" is endorsed. The cash basis is required to be used in general budget accounting and administrative unit Public service units may use the cash basis or accrual basis, depending on their specific circumstances,

*Changing the bookkeeping method***.** The bookkeeping method of fund receipts and disbursements is replaced by the double entry (debit and credit) system of recording.

Identification of accounting elements. The previous method focusing on sources of funds, application of funds, and funds balance is abolished. The new accounting elements now consists of assets, liabilities, net assets, revenues and expenditures.

Accounting equation. The revised accounting equation is now: assets = liabilities + net assets.

Expenditure. In the case of administrative units and public service units, the appropriated amount would replace bank disbursement as the reported measure of expenditures in the general budget accounting system.

Related Improvements. Corresponding improvements were made to the category and contents of accounting reports. For example, the change in fund activity statement became a statement of assets and liabilities, and various statements about financial flows were added.

2.3. Basic proposals for further reform

Currently, China's administrative management system, budget management and Treasury management systems are all undergoing extensive and profound reforms. In response to these, the government budget accounting system also needs to make corresponding reforms.

The account classification in general budget accounting requires revision to be consistent with government revenue and expenditure classifications. It is particularly necessary to set up account titles that directly relate revenue and expenditure categories, as well as budget appropriation categories.

In accordance with the "Financial Treasury Management System Reform: Experimentation Proposal," finance department will set up payment execution organisations to carry out the general budget accounting function.

In terms of general principles for accounting, research will be conducted on the adoption of the accrual basis of accounting. The new budget accounting system implemented in 1998 partially introduced the accrual basis in the accounting of public service units. It is worth considering whether the accrual basis should be introduced into the general budget accounting system. From the perspectives of increasing the transparency of the government budget, better assessing the benefits of use of financial resources, and consulting international experiences in government accounting reform, we have considered adding accrual basis as a major research topic.

We intend to continue to reform the accounting system of public service units. Public service unit accounting systems should be taken as a special case of the budget accounting system. Accounting principles used in enterprise accounting systems should be gradually introduced in public service units. Clear requirements are needed for fixed asset depreciation, overseas investment, income tax and other issues related to their economic activities.

3. The basic status of Chinese enterprise accounting reforms

3.1. Legal structure for accounting in China

Thanks to almost 20 years' efforts – particularly those during the last few years – China has preliminarily established a legal structure for accounting. The structure consists of Accounting Law at its core and supporting administrative laws and department rules and regulations. This has channelled the development of the accounting in the mode of legalisation and standardisation.

There are three levels in the hierarchy of Chinese accounting standards: namely, the Accounting Law, administrative laws in accounting and department rules and regulations. The "Accounting Law of the People's Republic of China" is promulgated by the Standing Committee of China's highest legal authority, the National People's Congress. It is the basic law for accounting in China. It specifically standardises such matters as the objectives of accounting, jurisdiction for managing accounting, accounting responsibility entities, basic requirements for accounting measurement and monitoring, the responsibility and authority of accounting personnel and accounting institutions, and legal liabilities connected to accounting. As such, the Accounting Law therefore provides the basis for engaging in accounting work, and serves as the premise for setting other accounting laws and regulations.

The second level consists of the administrative laws and regulations on accounting matters issued by the State Council, [which is China's highest executive authority]. They include, for example, "Provisions for Enterprise Financial Accounting Reports", and "Provisions for Chief Financial Accountants". The former covers all the business enterprises in China and sets standards on such topics as: the form and contents of their financial reports; disclosures in the notes of financial reports; the basis, premises, principles and methods for financial statement preparation; external reporting; accountable entities, and legal liabilities. Particularly noteworthy are the rigorous conceptual definitions for the six major elements of accounting: assets, liabilities, owner's equity, revenues, expenses and profit. The meanings of these definitions are almost completely identical with international accounting standards. These conceptual breakthroughs have played a very important role in guiding the reforms of accounting systems and the formulation of accounting standards.

The third level is the department rules and regulations related to accounting set by the Ministry of Finance. Examples include “Enterprise Accounting System”, enterprise accounting standards and supplementary requirements for accounting systems.

In addition to the above, some other laws containing provisions pertaining to financial accounting, financial report preparation, and information disclosures. These also provide legal support for accounting and monitoring. For example, the Company Law of the People’s Republic of China sets forth requirements for corporate finance, accounting systems, financial report preparation, auditing and external reporting. The Securities Law of the People’s Republic of China sets standards for the public offering of shares and debt securities companies’ financial information disclosure. In the Commercial Bank Law of the People’s Republic of China, there are requirements for setting up these banks’ financial accounting systems and for information disclosure. The Criminal Law of the People’s Republic of China provides for criminal liabilities for disseminating false financial reports and other illegal conduct in accounting matters. All these laws are passed by the Standing Committee of the National People’s Congress. Their high level of legal authoritativeness and strong binding effect provide powerful support for the legal basis of accounting and accounting system reform.

3.2. The goal and steps in enterprise accounting system reform

The goal of Chinese enterprise accounting system reform is to establish a systematic set of enterprise standards that is consistent with the socialist market economy, cognisant of China’s conditions, and is harmonious with international accounting practice. This goal has inspired a two-step strategy for reforming the Chinese accounting system. The first step is to effect the transformation from an accounting model based on a planned economy to that of a market economy. The second step is to formulate specific accounting standards on the basis of “Enterprise Accounting Standards – Basic Principles” in keeping with the pace of China’s reform and opening up and the needs of development in a market economy. After some years of effort, these steps are expected to lead to the establishment of a set of enterprise accounting standards for China. Specifically:

Model transformation. A strategic goal of the reform has been the transformation from an accounting model based on a planned economy to that of a market economy. The release and implementation of “Enterprise Accounting Standards” and “General Provisions for Enterprise Finance”, along with accounting systems classified by industry, accomplished this goal by 1993. This accomplishment is reflected in the following changes.

These documents have specified that accounting information should meet the needs for information by government departments and others in the society. For the first time, it is stressed that, besides satisfying the needs of the state, accounting information must also respond to the needs of investors, creditors and the general public. This reflects the diversity and pervasiveness of the needs for accounting information under the conditions of a market economy.

Chinese enterprise accounting standards now recognise the accounting equation of "assets = liabilities + owners' equity" common in international practice. They affirmed the concepts of such accounting elements as assets, liabilities, owner's equity, revenues, expenses and profit. These concepts scientifically reflect the scale, structure and quality of an enterprise's resources and its debt claims and obligations. They are also the premises for establishing a modern enterprise system, reforming tax and financial systems, properly defining the property rights in an enterprise, guiding effectively resource utilisation in an enterprise, and ensuring mobility of enterprise assets.

The standards have reaffirmed or introduced such accounting principles as relevance, accrual basis, matching and prudence. For example, the emphasis on the comparability of accounting information has unified the accounting policies under different ownership systems, management approaches and industries. When a society's resources are mobile in a market economy, the proper evaluation of all enterprises' financial status and operating results in the whole society creates the need for comparable financial information. As a further example, under the prudence principle, enterprises are required to rationally estimate likely losses and improve their capacity to prevent and manage risks, thereby protecting investors' interests.

The accounting standards implement the capital maintenance principle. As required by "two standards and two systems",[2] when an enterprise is established, it has to meet the statutory requirement for contributed capital. The contributed capital cannot be withdrawn by any means. [Capital asset] depreciation and asset loss are not allowed to diminish capital. The special account deposit system in practice for many years has been abolished to allow enterprises the discretion to move funds. These measures have played a very significant role in ensuring the preservation and appreciation of the value of state-owned assets and in safeguarding the equity of owners, including the state.

The standards also reformed cost management systems. Adopt the manufacturing cost method, management expenses and sales expenses in a period directly enter the calculation of gains and losses of that period. This has simplified cost accounting and helps to truthfully reflect an enterprise's financial status and operating results during the period.

Setting specific accounting standards. In keeping with the pace of China's reform and opening up, and to meet the needs of the development of the market economy, efforts were made to formulate specific accounting standards on the basis of "Enterprise Accounting Standard – Basic Standards". The following interim achievements have already materialised as a result of several years' efforts.

First, after almost 10 years, China has currently preliminarily established its set of accounting standards in support of the Accounting Law as guidance and covering basic accounting guidelines and specific accounting guidelines and accounting systems. Following the implementation of "Enterprise Accounting Standard – Basic Standard" in 1993, the exposure drafts of over 30 specific accounting standards were successively released. Thirteen of them were finalised and adopted for formal implementation. This caused a very significant response from the public, and produced favourable effects in promoting proper accounting and maintaining order in the market economy. These 13 accounting standards concern: related parties and disclosure of their transactions, cash flow statements, events subsequent to the balance sheet date, debt restructuring, revenues, investments, construction contracts, accounting policies, changes in accounting estimates and correction of accounting errors, non-monetary transactions, contingencies, intangible assets, loan expenses and leases.

Second, guidance for industry-specific enterprise accounting systems was given. Enterprises in different industries require guidance on how to implement the new accounting standards. We therefore summarised our experiences and formulated guidelines for all kinds of industrial and business enterprises. Based on the common demands by various enterprises in accounting, the systems provide a chart of accounts with 85 titles. The reports to be published include: a balance sheet, an income statement and a statement of cash flows. At the same time, supplementary disclosures include: a profit allocation schedule, a schedule of changes of shareholders' equity, a list of asset devaluation reserves, a segment report and a list of value-added tax payable. Also required was information about accounting policies and changes, transactions between related parties, events subsequent to the balance sheet date and contingency.

3.3. Basic proposals for future accounting reform in China

As China's market economy evolves further and its accession into the Word Trade Organisation fast approaches, the Chinese accounting profession, more than ever, senses the necessity of international co-ordination. We intend to gauge the pace of China's reform and opening up, and work toward the gradual harmonisation of Chinese accounting systems with international practice, particularly with international accounting standards. Specifically:

First, in order to complete the whole set of Chinese enterprise accounting standards, we intend to achieve the second target of accounting reform during the "Tenth Five Year Plan" Period. In the next five years, the release and implementation of the following specific accounting standards is planned: fixed assets, financial disclosures, interim reporting, inventory, owner's equity, accounts receivable, accounts payable, segment reporting, consolidated financial statements, business combinations, foreign current conversion, income tax, asset impairment, earnings per share, clearance, re-evaluation, disclosure and listing of financial instruments, pensions, business interruption, donations and government assistance, basic banking operations, insurance, petroleum and natural gas, discount, mining industries other than petroleum and natural gas, and agriculture. All these will form China's preliminary set of enterprise accounting standards.

Second, in response to the needs of financial system reform and small enterprise development, we intended to formulate accounting systems for financial institutions and insurance companies, as well as small businesses. The accounting for these businesses is rather different from that of other enterprises in general. They need complete and sound accounting systems to support system reform and development of small businesses.

Third, we intend to actively participate in the co-ordination of international accounting standards. As an information system that reflects the quality and efficiency of economic activities of an enterprise, accounting is closely related to the level of economic development. With the development of information technology, knowledge economy, economic globalisation and financial integration, international accounting co-ordination has become a major trend. During the "Tenth Five Year Plan" Period, we will still actively participate in international accounting co-ordination. In the process of formulating China's accounting standards, we will conduct thorough research on international accounting standards and the accounting standards of other countries. In particular, international accounting standards will be consulted in setting China's accounting standards. To the extent that they do not conflict with Chinese laws and regulations, international accounting standards would be adopted to the extent possible.

4. Concluding remarks

In conclusion, I would like to identify some important issues that need to be studied and solved in the course of Chinese Government budget management and accounting reform. These issues require theoretical answers and justification. On the whole, these issues can be generalised into the following aspects:

- how to establish a Chinese public finance system in service of the socialist market economy, and do so by using international experiences as a reference and taking into account China's specific conditions;

- how to further define the functions of government under the conditions of a socialist market economy, and how to divide the responsibilities between the central government and local governments;

- how to push forward budget management reforms in China by taking advantage of international experiences;

- how will government accounting and enterprise accounting face the new situation and requirements after China's accession into the World Trade Organisation;

- how to actively and steadily advance budget management reforms in China.

On the issues identified above, I sincerely hope that all the leaders and delegates from both China and abroad will fully express their views and opinions. We express our heartfelt gratitude for your contribution.

Reforming China's budget management system will profoundly transform traditional ways of budget management and will entail adjustments in the vested interests of various departments and units. Consequently, the tasks are enormous, as resistance to change is great. In order to ensure the smooth launching of the budget reform plan, we will continue to need the great support from the Party Central Committee, the National People's Congress and the State Council, as well as the vigorous support and co-operation from the various central government departments and the units under the State Council. The Ministry of Finance will earnestly pursue excellence in formulating reform proposals, modifying financial systems, designing software, preparing textbooks, training personnel and generating public opinion support. Our goal is to actively push forward reforms in China's budget management system, making it more scientific and standardised.

NOTES

1. These include (a) capital construction; (b) three expenditures for science and technology; (c) developmental innovations; and (d) scientific institutions. Capital construction refers to basic infrastructure projects. The three expenditures for science and technology are for testing new products, experimentation and subsidies for major scientific research projects. Developmental innovation projects are intended to tap the country's potentials and develop new ideas and products. Expenditures for scientific institutions include the administrative expenditure of government departments in charge of science and technology, and costs of running the research institutes in social sciences and high technology. Source: *Government Budget Receipt and Expenditure Account Classification Manual, Fiscal Year 2002*. – Editor

2. The "two standards" refer to Enterprise Accounting Standards and the General Provisions for Enterprise Finance. The "two systems" refer to Enterprise Accounting System and the accounting systems for various trades and industries. – Editor.

BUDGETARY AND FINANCIAL MANAGEMENT REFORM IN CENTRAL AND EASTERN EUROPE
BY
RICHARD ALLEN*

This paper describes recent reforms of budgetary and financial management systems in Central and Eastern Europe, with special reference to the 10 countries that are candidates for membership of the European Union (EU).[1] The paper is in two parts. Part 1 describes what the European Union expects and requires of its prospective members in the area of public budgeting and financial management. Part 2 describes the common problems countries have faced, the general approaches/solutions they are developing in the budgeting and financial management field and the gaps that remain. The paper draws heavily on the author's experience of leading the work on budgeting and financial management in SIGMA[2] during the period 1996-2000.

1. The EU framework

1.1. Introduction

Membership of the European Union imposes many obligations and requirements on member states – the obligations that derive from the Treaty of Rome (as revised by the Single Act and the Treaties of Maastricht and Amsterdam) and Community Law (all directives and regulations passed by the Council of Ministers), and the judgements of the European Court of Justice – are formally described as the "*acquis communautaire*". In the field of fiscal policy and budgetary management, these obligations mainly relate to compliance with fiscal policy targets (the Maastricht criteria), the provision of statistical data, anti-fraud procedures, and regulations concerning financial control and, to a certain extent, external audit. These areas are described below and a complete list is provided in Annex 1. However, in many areas of

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budgeting and financial management no EU rules and regulations apply, and it is the responsibility of member states to develop their own systems, under the so-called principle of "subsidiarity". Nevertheless, it is important for prospective member states to develop sound systems of budgeting and financial management even in areas where this is not formally required by EU law, in order to:

- permit the political and economic priorities of the government to be achieved within the budgetary constraints that always apply;

- ensure that government decisions are implemented efficiently and effectively;

- lay the foundations for operating effectively in the EU, and make good use of the aid funds that the Commission makes available to candidate countries prior to their accession;

- create confidence and trust in the relationship with other member states and the European Institutions, the Commission in particular.

Weak mechanisms for budgeting and financial management will obstruct the progress of a candidate country towards accession to the EU because:

- the country may not meet the necessary conditions of macro-economic and fiscal convergence, consistent with the Treaty obligations;

- problems may be encountered in the management of EU pre-accession funds that both impede the country's economic development and damage its relationship with the European Commission and member states.

The Commission has itself expressed the opinion that, in general, the budgetary and control systems of the candidate countries fall short of the required standards set by the Commission and by existing member states. In an Opinion issued in July 1997, the Commission referred to the need for candidate countries to develop their institutional and administrative framework in order to ensure effective administration of the *acquis communautaire* in the budgetary area:

the protection of the Community's financial interests requires the development of anti-fraud services, training of specialised staff (investigators, magistrates) and the reinforcement of systems of specific co-operation. The implementation of Community policies, especially for agriculture and the structural funds, requires efficient management and control systems for public expenditure, with provisions to fight fraud. Administratively it is essential to have a clear separation between external and internal audit. Police and judicial authorities need to be able effectively to handle complex transnational financial crime (including fraud, corruption and money laundering) which could affect the Community's financial interests.

In 1997, SIGMA published a two-volume study that describes the experience of national ministries of finance and Supreme Audit Institutions (SAIs) of seven EU member states in integrating national and EU budgetary procedures and requirements.[3] The following discussion draws heavily on this study and a related SIGMA paper.[4]

1.2. The budgetary impact of EU enlargement

Membership of the European Union will affect the budgetary systems and procedures of new and prospective members in several ways:

- in order to manage EU budgetary funds (both revenues and expenditures) in compliance with EU regulations,[5] each new member state will have to develop new systems for collecting, monitoring and evaluating financial information; and radically change their financial control and audit procedures, as described later in this paper;

- Community regulations substantially limit the capacity of member states to determine the structure and rates of VAT and customs duties. Over time, fiscal competition, operating through the single market and international trade, is likely to increase pressures for bringing the rates and structures of other taxes towards the "average" or "general" level in the Community as a whole;

- the development of the European common currency (the Euro) and the implementation, under the Maastricht and Amsterdam Treaties, of the so-called macro-economic "Stability Pact", will greatly sharpen the need for fiscal discipline in the member states and require them to strengthen their budgetary systems and procedures;

- member states will have to exercise greater control over the financial behaviour of local authorities' budgets and funds such as social security which, in many countries, are not counted as part of the state budget but affect the overall level of expenditure and borrowing by the public sector.

1.3. The EU budget process

The Commission, Council and European Parliament all contribute to the process by which the EU's budget is adopted annually, with the Parliament taking the final decisions in most areas. The process is a long and complicated one – starting in February and usually finishing in December. Each member state is expected to give its opinion not only on the macro-economic framework fiscal policy objectives of the budget but also on the detailed expenditure proposals. Familiarisation with the budget process and procedures is an essential priority for any new and prospective member state.

Member states contribute all the EU budget's revenue and execute more than 80% of the spending, though the Commission retains ultimate responsibility for implementing the budget. From a member state's point of view, some EU budget expenditure (*e.g.* on agricultural programs) is intended to replace equivalent national expenditure. Other programs (*e.g.* structural funds) are intended to be additional to the equivalent national programs.

A member state needs to equip itself to perform three main types of role in relation to the EU budget:

- An *information* role: the member state needs reliable information, in an accessible form, in order to monitor and forecast the impact of the EU budget on the national budget; it is also an essential source for the Commission of budgetary data, notably forecasts of own resources, movements of agricultural stocks and expenditure on structural funds programs. Under the Treaty, the member states have a general duty to assist the Commission in its responsibility for managing the budget.

- A *negotiating* role: each member state strives to achieve an allocation of revenue and expenditure through the EU budget outcome that is compatible with its national policy priorities. To do this, a country uses its position as a member of the Council of Ministers and its negotiating strength with the Commission.

- A *compliance* role: the member state must comply with all relevant EU rules about the collection and transfer of the EU's budgetary revenue and the proper management of funds received from the EU budget. It must be vigilant in preventing, detecting and reporting fraud and irregularities against EU funds. The Commission requires a member state not only to comply with the rules, but to be able to demonstrate after the event, on the basis of documentary records or other evidence, that it has done so.

For new and prospective member states, effective fulfilment of these roles is likely to involve some changes in the machinery of government and the expenditure of additional resources. Accounting and audit expertise, and computing resources, will be of special relevance. There is hardly any season of the year when budgetary business of one sort or another is not on the Council agenda at ministerial or official level in Brussels. The range of interests affected by the EU budget, and the speed of response required from national representations in Brussels, make it imperative for a member state to have effective procedures in place for co-ordinating the views of different government services.

The national budget is the principal instrument used by existing member states in order to account for the flows of funds to and from the EU budget. Receipts from the EU are entered on the revenue side of the national budget (or occasionally shown as negative expenditure) while the expenditure side shows the disbursement of the same funds to beneficiaries and part (or sometimes all) of the national contribution to the EU budget. This treatment is not a requirement of EU law, and there are significant differences between the practice of different member states. For example, the United Kingdom enters all transactions with the EU budget on the expenditure side of the national budget. The Finnish authorities account for the price support subsidies of the Agriculture (Guarantee) Fund in a separate intervention fund which is outside the budget and endowed with its own borrowing power. There are, however, rules on the way in which flows of funds involving the EU budget must be treated for national accounts purposes.

Since most member states use gross accounting in their budgets, this treatment adds EU funds to budget totals of both revenue and expenditure. The gross accounting solution has the advantage of convenience, and this is the main reason why member states have adopted it. Most of the flows of funds can be accommodated without difficulty in existing budget headings. More importantly, from both a national and EU point of view, this practice ensures that the same safeguards and controls are *ipso facto* applicable to EU funds as to national budgetary funds. This approach seems to have practical as well as cost advantages. It also facilitates compliance with the Maastricht Treaty which requires member states to be equally conscientious in the protection of EU and national financial interests.

1.4. The role of the Ministry of Finance

If a member state is to manage effectively the EU budget process, and integrate this into its national budget procedures, the Ministry of Finance must play a central role. In western countries, Ministries of Finance are both an important part of the small group of policy-making ministries and offices at the "centre of government" and, in many cases, provide direct advice to the Prime Minister on economic and financial issues. They thus play a crucial role in the planning and execution of the national budget (and its links with the EU budget) and in the policy-making process itself. For example, line ministries and other spending agencies will usually be required to obtain the Ministry of Finance's opinion before any policy proposal that has financial and public expenditure implications is submitted to the Council of Ministers. In addition, the Ministry of Finance will typically provide technical support to spending agencies in analysing the economic and financial implications of policy options, and to challenge these agencies if the information or analysis they provide is inadequate; to establish a common framework – through the issuing of regulations and guidance to line ministries – on financial management and control techniques and systems; and to verify that these systems have been implemented effectively.

Such functions, which require the necessary constitutional and legal powers, a high level of technical skills and very good access to financial information, are still beyond the capacity of Ministries of Finance in many Central and Eastern European countries. The responsibilities of such ministries, in the budget and control area, often do not extend much beyond the legal requirement to act as "paymaster" to government spending entities. Thus, in these countries, there is commonly no requirement for the Ministry of Finance to take responsibility for ensuring that public expenditure achieves value for money (economy, efficiency, effectiveness) or that the financial management procedures and systems (staff, IT, training, etc.) of spending agencies are organised within a common framework and meet internationally recognised standards of regularity and efficiency. One major challenge for countries in Central and Eastern Europe is to provide their Ministries of Finance not only with the legal authority to fulfil such functions, but also with the necessary technical skills and other resources for carrying them out.

Strengthening the powers of the Ministry of Finance relative to other ministries is, of course, a sensitive matter for most countries, and will need careful preparation and management.

1.5. Customs and tax administration

A prospective member state will need to adapt its frontier and domestic taxation arrangements in order to deliver to the EU sufficient sums of “own resources” (customs duties and agricultural levies) and the required share of VAT revenue. In the case of Portugal, for example, one of the major problems of accession was the necessity to improve officials’ skills at all levels in the customs administration. The solution adopted was a comprehensive training course in the Commission for customs officials. Accession to the EU will involve the adoption of EU levels of levies and customs duties (subject to any transitional arrangements), including any changes that may be required in national legislation. It will also involve the introduction of a VAT system of indirect taxation where such a system does not already exist.

The provision of EU-compatible GNP data can also cause difficulty for new member states. The Swedish authorities have commented: “With regard to the various types of payment that constitute our own resources in the EU budget, VAT-based payment is the most complicated and requires new calculations and good statistical documentation ... it is also essential to adjust the system of national accounts in such a way that it can supply the information required to calculate the GNP-based payment”. This will require upgrading the capacity and skills of national statistics offices. In candidate countries, an early start should be made in planning and implementing the necessary changes.

While the overall evolution of a member state’s budget contribution is a matter for the Ministry of Finance, the management of its component parts is likely to involve different agencies and levels of government. Policies and procedures concerning agriculture, customs administration, indirect taxation and statistics are among the main areas concerned. Most member states have found it necessary to set up a specialist unit within the budget sector of the Ministry of Finance to co-ordinate all action connected with the calculation, reporting and payment of their contributions.

There are two other important implications of EU integration for customs and tax administration in new and prospective member states.

First, the trend in tax collections in the customs area is strongly downwards. Internal duties will disappear with the completion of the single market within the EU, whereas external duties have been reduced under successive "GATT rounds" of international trade negotiations. An important implication of EU membership is that customs services will have to adapt their administrative systems to these changing circumstances and pressures. For example, the Schengen principles, where applicable, will lead to a withdrawal of all customs officers from border posts. Similarly, border controls for VAT collection purposes have been removed. Some customs administrations are responding to these developments by downsizing their traditional operations and redeploying resources into areas such as controls of drugs and money laundering. This implies an ever increasing need for co-operation between the customs services, police and judicial authorities in the member states.

Second, the expected impact (indeed the objective) of the single market is to create a much more open, competitive and flexible market, not only for goods and services but also labour and capital. As noted above, this has led to growing tax competition and further restrictions on member states' freedom to make changes in the structure and rates of taxes for macro-economic or micro-economic policy purposes. Moreover, viewed from a Community perspective, the tax base will become progressively more mobile, fluid and volatile and thus more difficult to monitor and "capture" by national tax authorities. As a consequence, there will be pressures for stronger intra-European co-ordination between the tax authorities, for example, through exchanges of information, files and staff.

1.6. EU regulations concerning the Agriculture and Structural Funds Programs

Agriculture (Guarantee) Fund. The Agriculture (Guarantee) Fund accounts for about half the total expenditure of the EU budget. Day-to-day management of the relevant expenditure is devolved to member states, which is fully reimbursed by the Commission. There is a delay of at least two and a half months between disbursement of funds to beneficiaries and reimbursement by the Commission. A new member state must therefore be prepared to provide the initial start-up finance.

Each of the various measures financed by the Fund is defined in permanent, specific legislation (*i.e.* regulations issued by the Council of Ministers or the European Commission). The annual budget authorises sufficient funds to enable the member states to fulfil their obligations to beneficiaries in accordance with the different measures. Expenditure on some of the measures, notably those directed at price support, is volatile and difficult to forecast. Numerous working groups in Brussels try to keep track of the expenditure from month to month, while other working groups examine Commission proposals for new or amending legislation – typically with a view to strengthening financial and accounting controls in member states, and reducing the risk of fraud. This activity makes significant demands on the time (and negotiating skills) of a member state's agricultural and budgetary experts.

The member state is obliged to set up one or more paying agencies as the vehicle for disbursement to beneficiaries of receipts from the fund. Paying agency status is granted (by the member state) only to bodies which can demonstrate an ability to maintain high standards of accounting, financial management and financial control. The criteria which a member state has to apply in deciding whether to grant paying agency status were spelt out in detail in a 1995 Regulation (Regulation 1663/95). This regulation represented an important departure from the EU's previous practice of allowing member states to interpret EU financial control requirements in the light of their national administrative traditions and practice. The member state must also select a certifying body (which must be operationally independent of the paying agency and need not be in the public sector) to audit the annual accounts of each paying agency.

Under the so-called "clearance of accounts" procedures, the Commission reviews the paying agency's annual accounts in the light of the certifying body's audit. In addition, and separately from the annual accounts, the Commission may subject the paying agency's handling of EC funds to a more searching audit of compliance with EU rules. This sort of audit often covers more than one member state. If the Commission finds evidence that the paying agency has failed to comply with EU rules, it reduces the agency's current year funding by an amount which reflects the Commission's assessment of the loss to EU funds.

The paying agency is also subject to audit by the European Court of Auditors, the EU's external audit body. The Court has no direct power to sanction member states, but its findings, which are presented to the Council and the Parliament, may lead the Commission to recover any irregular payments and, in certain cases, to terminate further payments to the country concerned. Member states are increasingly expected to reply to any criticism of their management of EU funds by the ECA and to explain what they have done to put things right.

A paying agency needs staff who are familiar with both the agricultural and the budgetary legislation of the EU and a place within the structure of government that enables and encourages the staff to co-ordinate their work with their colleagues in the Ministry of Agriculture and the Ministry of Finance. Above all, the paying agency needs staff who are competent in financial management and an organisational structure that gives due weight to the requirements of financial control.

Structural Funds. The Structural Funds co-finance multi-annual programs in the member states. In contrast with the expenditure of the Agricultural (Guarantee) Fund, where payments from the fund are largely determined by formula, there is a substantial discretionary element in the spending of the Structural Funds. Taking full advantage of the Structural Funds is a labour-intensive exercise for member states, both for this reason and because of the extensive co-ordination which is required to satisfy the requirement of partnership that is fundamental to the Structural Funds' operations.

For the national authorities, the preparation of bids for aid involves co-ordinating the views of different government agencies, different levels of government and non-governmental bodies. The monitoring of existing programs is another collective operation, in which representatives of national, regional and local government and of the Commission participate. For historical reasons, there is some overlap between the objectives supported by the different funds. As a result, co-operation with the Structural Funds has led to increases in the workload and changes in the procedures of some governmental agencies in most member states, and in some cases the creation of new structures, such as the special units set up by the United Kingdom and the Portuguese authorities, in the latter case prior to accession.

1.7. Financial control

In the area of financial control, member states are required to verify the efficiency and regularity of all operations aided by the Structural Funds, and to inform the Commission how they propose to fulfil that obligation. They also have a specific obligation to certify the validity of claims for payment, and in the case of final payments arrange for an independent certificate. These obligations are less comprehensive and less detailed than the criteria which Regulation 1663/95 established for the authorisation of paying agencies. Nevertheless, in at least one case (Sweden) they were a contributory factor in a government decision to set up new internal audit units in the principal government agencies responsible for handling receipts from the Structural Funds.

The European Commission can and does conduct on the spot audits of Structural Funds expenditure in the member states, and may also require the member state to carry out specific enquiries. The operations of the Structural Funds are also subject to audit by the European Court of Auditors. Any evidence of irregularity is likely to lead to a demand from the Commission for the member state to reimburse the amount lost and a financial penalty.

The activities of the various financial control and audit services at EU and national level have not always been co-ordinated to best effect. It is clear that countries have to find new and more efficient methods of co-ordination. This is partly a matter of the institutions concerned committing sufficient resources and time to the task, partly a matter of agreeing between themselves a common approach and methodology.

Co-ordination has not been helped by a lack of clarity in the division of responsibilities between the multiplicity of financial control and audit services in the ECA, the Commission and member states. However, it seems that co-ordination has improved in recent years, and at the same time there has been increased involvement of national financial control and audit services in the safeguarding of EC assets.

The position remains more fluid in relation to the Structural Funds. With a view to making the best use of all the EU's financial control and audit services, the Commission's financial controller has invited member states to sign protocols which would co-ordinate both the timetable and the methodology of work by the Commission's and member states' financial control/audit services. This proposal has caused some difficulty for member states with federal constitutions and/or decentralised systems of financial control, but about half the present member states have already signed protocols and negotiations are well advanced with the others. Early negotiation of a protocol could provide a candidate country with useful insights into the scope and frequency of financial control work which it would be expected to carry out after accession, the minimum standards which the Commission would expect that work to meet, and thus the extent to which existing financial control and audit services might need to be strengthened prior to accession.

In relation to the aid funds that candidate countries are eligible for prior to accession, strict Community rules relating to procurement, financial control and reporting are also applied. In 1999, the European Union took an important step towards decentralising the financial management of pre-accession funds when it adopted Council Regulation 1266/1999. Through this measure, the EU has created the possibility of waiving the statutory requirement of *ex ante* control of expenditure by the European Commission. This will allow prospective member states to manage and control pre-accession funds if the implementing and paying agencies they set up to manage the funds fulfil specific minimum standards concerning operating procedures, internal controls, procurement rules, adequate staffing, etc. But so far no such decisions have been taken.

The European Commission is currently in the process of strengthening its internal financial control system by delegating operational responsibility for financial control and internal audit to the line directorates-general, creating a new Internal Audit Service and a high-level Audit Progress Committee. Anti-fraud activities have also been strengthened by creating a new, more powerful anti-fraud office (OLAF) that reports directly to the European Parliament. Budgetary resources devoted to financial control, internal audit and anti-fraud activities have been substantially increased.

1.8. External audit

The Treaty amendments which set up the European Court of Auditors introduced the first ever reference in Community legislation to national Supreme Audit Institutions (SAIs). The ECA's audit work in member states is required to be carried out in liaison with SAIs; SAIs are required to inform the ECA whether they intend to take part in the audit; and are also required to forward to the ECA, at its request, any document or information necessary to carry out its task.

Over the past decade, the Commission, as the EU institution responsible for implementing the Community budget, has taken an increasingly active interest in the effectiveness of the control measures applied by member states to Community funds. It has taken important initiatives designed to involve national control services in the audit and control of agricultural subsidies and the structural funds, and to ensure that the standard of their work meets certain minimum criteria. The responses of SAIs to these initiatives have varied. While the Community has legislated about SAI/ECA relations, it has never attempted to regulate the SAI/Commission relationship by law.

It seems likely that the Commission will continue its policy of prescribing control and audit procedures for member states to follow and of requiring them to observe certain minimum standards in so doing. Enlargement, with the additional demands that it will place on the Commission's own control and inspection services, has added a new impetus to the process.

Most SAIs consider that accession has led to a noticeable but not a significant increase in the volume of their audit work. The United Kingdom's National Audit Office, for example, has estimated that EU-related work takes up approximately 2% of its time which "is broadly in line with the proportion of United Kingdom expenditure provided from the European Community Budget". This sort of calculation does not do justice to the unquantifiable changes in approach and organisation which accession has brought about for some SAIs. The audit of compliance with EU rules requires a substantial initial investment by the SAI in familiarisation and training. And implementation of the new rules can generate additional audit risk.

The extent of the cultural shift which can be needed is brought out in the following observation of the Swedish SAI: "We cannot exclude the possibility that, to some extent, the reason for mismanagement, irregularities, fraud and corruption in the EC payments system lies in the way the system is designed. If national and "European" budget funds are used for the same purpose, there may be a greater risk of error in relation to a relatively complex regulatory structure ... the fundamental approach and structure implicit in the administration systems of control which now apply to Sweden as a result of EU membership differ in certain important respects from our national practice. This means that it is not always easy for Swedish officials to understand and implement these control systems". The auditor, in planning his priorities, has to take into account the risk that national systems of administration may not devote the same care and attention to the management of EU funds as they would to national funds.

There is now a well-established liaison routine which covers the scheduling, implementation and follow-up of ECA audits in member states. The *a priori* conditions are that, basically, each body must itself determine whether co-operation will give it some added value. Within the Community, there are some differences in national approaches to co-operation with the ECA. The option in the Treaty for SAIs to take part in ECA audits is interpreted in a variety of ways. However, participation has normally taken the form of attaching a representative of the SAI to the ECA audit team as an observer.

The SAIs and the ECA have been co-operating since the early 1990s to carry out a limited number of joint audits. These are audits in which the ECA and one or more SAIs pool their resources in a single audit enquiry. As a variant on that idea, there have also been some experiments with parallel or co-ordinated audits, in which two or more audit bodies carry out separate enquiries into the same subject area. Several SAIs have emphasised the educative value (for both parties) of joint audits. SAIs have also drawn attention to the relatively heavy demands which all forms of co-operation with the ECA place on their available human resources.

Another form of co-operation between SAIs and the ECA relates to the ECA's obligation under the Treaty to provide the European Parliament and the Council with a Statement of Assurance (SOA) as to the reliability of the accounts and the legality and regularity of the underlying actions. This is a very specific responsibility which places a responsibility on the auditor to ensure, and if necessary to be able to demonstrate, that his conclusion is supported by the audit evidence.

The ECA has been seeking to negotiate bilateral arrangements with SAIs on a voluntary basis in order to enable it to use the results of SAIs' audit work as an input to the SOA which the ECA has to give, at the end of each year, on the overall EU budget. The object of the negotiations is to reduce the ECA's workload in connection with the SOA and/or to strengthen the basis on which the SOA rests. A key question is the extent to which the ECA is satisfied that the SAIs' audit results are reliable. There is a relationship here with the recent initiatives of the Commission referred to above. In both cases, the national control bodies operate according to standards laid down by or agreed with Community institutions. The negotiations have not yet been concluded, but if they are successful it might suggest that this sort of arrangement, in which the roles of the two parties are complementary rather than additive, represents a more cost-effective model of co-operation for the future than joint audits.

Member states have responded differently to the two Commission initiatives referred to above. In France, Sweden and the United Kingdom, for example, the national authorities have appointed their SAIs as certifying bodies under Regulation 1663/95. In recognition of the unusual nature of their role in this matter, the French *Cour des Comptes* has set up an auditing commission to handle the certification work, and the United Kingdom's National Audit Office has entered into a contractual relationship with its national paying agency.

1.9. Conclusions

It is important for candidate countries to make an early start to making preparations for EU membership. Several years of preparatory work are needed and many practical questions require deep and careful consideration. Countries that have based such preparatory work on early policy decisions, laying down the principles that will guide the implementation process, find this to have been of great value.

Training of staff is an essential element in preparation. Training in financial management skills, and in the standards and methods of internal control and audit, is equally important. Language skills are also important.

For new and prospective member states, effective integration into the Community is likely to involve changes in the machinery of government and the expenditure of some additional resources. The financial control and audit systems in government administration have to be changed, often in a fairly fundamental way. In addition, preparation for membership demands a thorough analysis, adaptation and development of existing budgeting, financial control and audit systems. Additional resources – to design and build new financial information systems, for example – may be required.

The requirements to conform with detailed EU budgetary and control regulations and procedures – and, more broadly, with the needs of fiscal discipline implied by the Maastricht Treaty – put pressure on new and prospective member states to strengthen their administrative systems and processes in a range of institutions including national statistics offices, tax and customs authorities and Ministries of Finance. New systems of internal control and internal audit need to be designed and implemented. Strong and responsive arrangements are required, with the Ministry of Finance playing a leading role in co-ordinating the views and actions of different ministries with interests in the EU budget. Usually, this also includes a clear overall responsibility for the government-wide development and implementation and of internal control and internal audit standards.

It is important for member states to have effective procedures in place for co-ordinating the views of different ministries and other government agencies. Candidate countries need to supplement their formal contacts with the Commission and member states with close and continuing informal contacts at all technical levels, as well as at senior official and political level. Negotiating a protocol on financial control and audit with the Commission is one means which an applicant country might use to build closer working relations with the Commission and, at the same time, deepen its understanding of the EU's financial control system.

In strengthening their financial control, internal audit and external audit systems, the experience of existing member states highlights the importance of developing an integrated and co-ordinated approach in which the relevant authorities in government, notably the Ministry of Finance, and the SAI should work closely together.

2. Progress in Central and Eastern Europe

2.1. Introduction

It is useful to assess the quality of a country's budgetary and financial management systems against a number of baselines that are described below. These baselines are intended to be minimum standards of performance based on the systems in place in EU member states and internationally accepted standards of good practice. Having described the baselines, this paper evaluates the progress made by candidate countries in achieving the standards, and the further actions that they need to take in order to deal with the gaps that remain.

Baselines were developed by SIGMA in four areas of budgeting and financial management – public expenditure management, financial control, public procurement and external audit. Assessments were carried out on each of the 10 candidate countries in 1999 and 2000, in each of these four areas, and the country's performance was rated on a scale of 1 to 4 (with 4 being the best) against a range of criteria. Assessment reports were delivered by SIGMA to the European Commission,[6] which then used this information in preparing its annual reports on the progress that candidate countries have made towards EU accession. The main questions and criteria that comprise the baselines are described below.

2.2. The baseline measures[7]

Legal and institutional framework. There should be clearly defined principles of public budgeting set out in the Constitution, the organic budget law and/or related laws. These principles should:

- provide a clear, transparent and comprehensive definition of public money;
- determine that all public funds are managed within the law;
- establish the relationship between Parliament and the Executive in budgetary matters;
- define rules and procedures on intergovernmental fiscal relations;
- ensure the comprehensiveness of the budget;

- define the different classes of budgetary institutions, enterprises and agencies and the linkages of these organisations to the budget;

- provide a legal basis for the formulation and execution of the budget and the roles, responsibilities and powers of the Ministry of Finance.

The regulatory framework should provide a sound balance between the legislative and the Executive branches of government. Parliament must be able to properly scrutinise the budget, and debate and review fiscal policies. Committees for budget, finance and public accounts need to be created and/or strengthened. Parliament's links with the SAI should be reinforced. For good macro-economic management and efficient allocation of resources, the budget should cover all revenues and expenditures. Extra-budgetary funds (EBFs) and EU budget funds, *e.g.* pre-accession assistance channelled through the National Fund, should be integrated into the state budget.

Medium-term fiscal framework. Future EU member states should be able to provide budgetary information within a medium-term framework, and set medium-term fiscal objectives. Once they become EU members, either within or outside the European Monetary Union, they will have to submit either Stability or Convergence Programs. Both programs will have to specify the main elements of a medium-term fiscal framework that complies with certain methodological principles and standards (*e.g.* ESA95 on national accounts statistics).[8] Candidate countries are also required to use a medium-term framework in submitting proposals to the Commission for pre-accession aid under the SAPARD, ISPA and Phare Programs.

Budget preparation process. There should be a well defined, and widely understood sequence of steps in the budget preparation process, allowing sufficient time for each step to be implemented efficiently. Hard budget constraints should be built into the processes. The draft budget put forward to Parliament should be presented in an appropriate format to allow Parliament to scrutinise it properly. It should specify fiscal policy objectives, the macro-economic framework, the budget policies and identifiable major fiscal risks. The draft budget should provide a clear and comprehensive plan for all public spending; the linkages of expenditures to specific organisations, objectives and activities; funding that relates to new activities; the hierarchy of accountability amongst persons and organisations entrusted with public funds; and clearly defined appropriations to be voted by Parliament. The language and format of the draft budget should be accessible to citizens and media as well as to legislators.

Budget management of public investment policies and programs. The European Commission expects candidate countries to prepare themselves for managing the assistance from the pre-accession funds so that when they join the EU, they have the required budget instruments in place. The expenditure programs funded by pre-accession aid are a mixture of capital and operational expenditures. In order to comply with EC requirements, governments in candidate countries should have the capacity to present multi-annual programs involving careful co-ordination between partners at different levels of government, well designed co-financing procedures and sound technical and economic appraisal of such programs. Administrative procedures for preparing and approving budget proposals for capital expenditures should be integrated with those for operational expenditures.

Budget execution and monitoring. The Ministry of Finance should be able to set limits on public expenditure programs and enforce these limits. It should monitor and control the flow of expenditures during the year on the basis of a unified system of financial accounts. However, the number of individual appropriations in the budget should be limited to only a few for each spending entity: this increases the ability of line ministries to manage their budgets and enhances the control function. Line ministries should make regular reports to the Ministry of Finance that compare actual spending with monthly forecasts based on the budget appropriations. Parliament and the Council of Ministers should have appropriate responsibilities for reviewing periodic reports on financial performance against the budget plan and for revising targets and/or policies as required by changed economic or financial circumstances. The cash management or Treasury function should be strictly managed through a Treasury Single Account under the control of the Ministry of Finance.

Accounting and reporting. Budget and accounting categories at the national level should have a common set of classifications that facilitates policy analysis and promotes accountability. Accounting conventions and procedures need to be made compatible with concepts related to the disbursements of EU funds – commitments, payments, eligible expenditures, etc. Fiscal reporting should be timely, comprehensive, reliable and identify deviations from the budget. Procedures for evaluating the efficiency and the effectiveness of expenditure policies and programs – including those funded from EU sources – should be established.

Financial control. Coherent and comprehensive legislation defining the systems, principles and functioning of management, or internal control, is required. The following systems and procedures are the most fundamental for sound internal control: *i)* accounting and reporting standards, regulations and systems; *ii)* a defined audit trail, which for the management of EU funds should clearly define the roles and the responsibilities of the different national entities involved including, in the case of EU pre-accession funds, the National Funds and Paying Agencies; *iii) ex ante* controls of commitments and payments; *iv)* procurement control; and *v)* control of state revenues.

An internal audit/inspectorate system, with appropriately defined organisational structure, responsibilities and powers, should be put in place. It should meet the following criteria: *i)* be functionally independent; *ii)* have an adequate audit mandate; and *iii)* use internationally recognised auditing standards. Systems must be in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence.

Public procurement. Achieving a properly functioning market is one of the priority tasks of the EU. One of the key ways of achieving this goal – and other related and essential elements of good governance – is to have a properly functioning public procurement system whereby competition is encouraged for contracts awarded by public and private bodies. Sound and transparent procurement policies and practices can reduce costs of public expenditure, produce timely results, stimulate the development of the private sector, reduce waste, delays, corruption and government inefficiency.

Measures to improve procurement include: *i)* the establishment of sound public procurement legislation; *ii)* creating a central public procurement organisation with overall responsibility for the design and implementation of public procurement policy; *iii)* strengthening the capacity of procuring entities; *iv)* implementation of a national training strategy; *v)* the establishment of effective complaints review procedures; and *vi)* rigorous enforcement of procurement legislation through effective internal control and internal audit mechanisms.

External audit. It is important for each country to have a Supreme Audit Institution (SAI) with clear authority for auditing all public and statutory funds and resources, bodies and entities, including EU resources. The type of audit work carried out by the SAI needs to cover the full-range of regularity and performance audit set out in INTOSAI auditing standards. The SAI should have the necessary operational and functional independence, as well as sufficient resources and trained staff, to fulfil its tasks.

Other important conditions are that the SAI should: *i)* produce annual and other reports in a fair, factual and timely manner; *ii)* have its work effectively scrutinised by government and parliament, *e.g.* by a designated parliamentary committee that also reports on its own findings; *iii)* adopt internationally and generally recognised audit standards compatible with EU requirements, and ensure that these standards are implemented; and *iv)* be fully aware of the EU accession process and the formal requirements relating to financial control and audit.

Capacity for upgrading the systems of budgeting and financial management. In addition to the technical criteria described above, the capacity of a country to bring its budget law and financial management procedures into line with western European standards will depend on a number of factors including:

- the existence (or not) of a coherent strategy for change;

- the existence (or not) of a sustained high-level commitment to change.

Specific indicators of the willingness and capacity for change might include, *inter alia*:

- the existence of a separately identifiable department or unit – in the Ministry of Finance and other ministries or agencies concerned – responsible for modernising the budget system, and integrating it with EU concepts and procedures;

- the organisational position of such units and their potential level of influence;

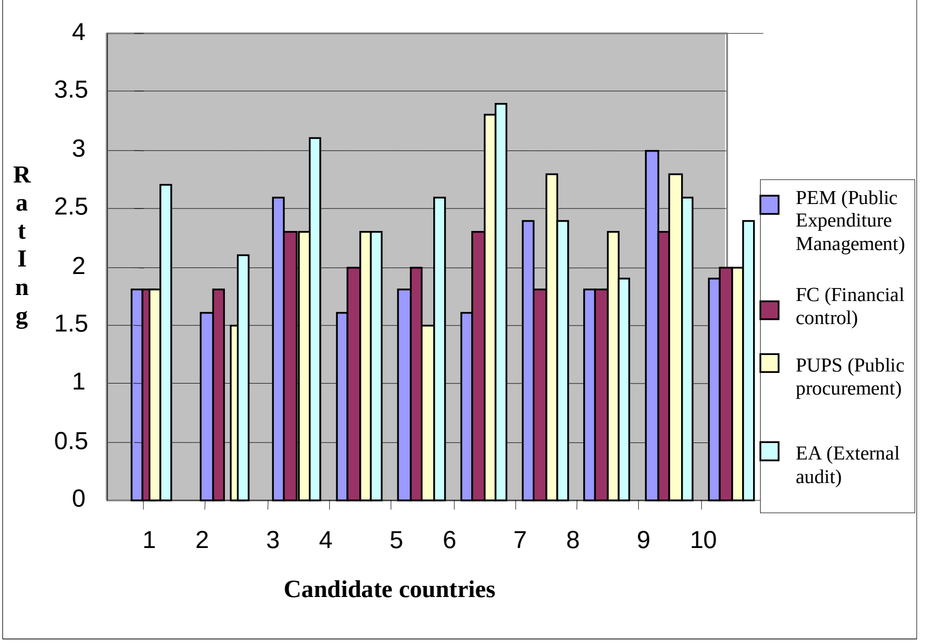
- the number of professionals working in the fields of budget, control and audit, and their level of skill, motivation and efficiency.

2.3. An overview of progress made in the candidate countries

The candidate countries all appear to recognise the importance of effectively managing the current expenditures of the core state sector – ministries and operating agencies. In building effective processes for managing government finances as a whole, however, they are still burdened by their inheritance from the former Soviet regime. These issues include poorly defined allocation of budgetary responsibilities between the Ministry of Finance, line ministries and other budgetary institutions; the existence of numerous extra-budgetary and “special” funds; separation of decision-making on capital investment programs and operational budgets; weak accounting and reporting standards; poor linkages between budgets and results; and no tradition of multi-year financial planning.

Graph 1 summarises the work carried out by SIGMA in evaluating the candidate countries' performance in 2000 in the four areas of public expenditure management, financial control, public procurement and external audit. (In the graph, the countries are identified by number, 1-10, and not by name.) None of the candidate countries has yet achieved an acceptable standard in all of these areas.[9] However, it should be recognised that the situation is evolving. Several countries are proceeding with ambitious reform programs that are underway but not yet completed. The Commission, World Bank, IMF and other donor institutions, multilateral and bilateral, are providing substantial technical assistance. If these efforts are sustained, these countries could expect to see a significant upward adjustment of their performance ratings in 12-18 months time.

Graph 1. **Rating of candidate countries**



The progress of the candidate countries against each of the 10 baseline categories defined in Section 2 above is described below.

Legal and institutional framework. In most of the candidate countries, the legal basis for the main elements of budgeting and financial management is at least reasonably comparable to that found in EU member states, especially when new legislation pending in the respective Parliaments is considered. In some countries, however, further legislation is required to deal with issues such as the design and implementation of a medium-term budgetary framework, the integration of budgeting procedures for capital investment and operational expenditure, and bringing the arrangements for procurement, internal control and internal audit into line with EU requirements.

In many countries, there remains a serious problem of budgetary fragmentation centring on large numbers of extra-budgetary funds (EBFs) and poorly defined, loosely regulated public agencies. The existence of EBFs creates difficulties in making needed trade-offs in resource allocations in line with government priorities and in effectively managing and scrutinising the use of resources (including co-financing of EU projects). In many countries, there is a serious lack of budget transparency involving the use of quasi-fiscal transactions, contingent liabilities and government guarantees. In a few countries (*e.g.* the Czech Republic, Estonia and Hungary), action has been taken by the government to increase public access to information on these items and to provide more accurate information on the recorded level of the budget deficit.

Medium-term fiscal framework (MTFF). Establishing a multi-annual fiscal (or expenditure) framework is important as a basis for efficient planning of public expenditure and to achieve compatibility with EU procedures. Performance in this area is mixed. A few of the candidate countries currently present information to Parliament on a multi-annual basis. Some countries have certain basic elements of such a framework in place, but the econometric modelling techniques supporting the preparation of multi-annual economic and fiscal projections are weak and often hampered by unreliable and incomplete statistical information.

Budget preparation process. Most candidate countries have essentially a bottom-up approach to budgeting and few set firm ceilings on spending early in the process. In many countries, the budget documents are of limited practical use and lack transparency. Moreover, in many cases, the government's medium-term economic and fiscal assumptions and/or projections are not disclosed to Parliament and the budget timetable is unduly compressed. In a number of countries, the budget includes too many line items and there is no flexibility to shift funds among these lines. Many countries have modern budget classification systems but few have sufficient data on outputs and programs.

Budget management of public investments. Budgeting for capital investment is not fully integrated with budgeting for operational expenditure in any candidate country, though there are some indications of improvement. In some of the countries, the separation is even more extreme, with the capital investment program managed by the Ministry of Economy, rather than the Ministry of Finance. In most countries, there are weaknesses in the capacity of the Ministries of Finance/Economy and line ministries to undertake essential micro-economic analysis of capital investment proposals.

Budget execution and monitoring. A few of the candidate countries appear to have reasonably good systems of cash management in place. The others are at earlier stages of development. Some countries have not yet installed a Treasury Single Account/Treasury General Ledger (TSA/TGL) system but are planning to do so.[10] In most countries, line ministries have some flexibility within the fiscal year to reallocate budget resources, particularly for salaries, from one category to another. Scope for carrying over unused funds from one year to the next is, however, much more limited. Some countries have moved ahead with the development of procedures for managing Phare and EU pre-accession funds through the National Fund, but others are lagging behind.[11]

Accounting and reporting. This is another area in which serious weaknesses are still found in most Central and Eastern European countries. In many of the countries, the budget classification system does not yet conform with international standards, *i.e.* GFS and COFOG.[12] Typically, the accounting standards are not consistent with international practice. In several cases, the countries are unable to produce national accounts conforming to ESA95. In most cases, the external auditor does not provide an opinion on the government accounts that conforms to international standards. In some countries, there are serious delays in reporting on budget implementation. One country has not published budget reports for the last two years.

Financial control. Over the past year, public bodies in some candidate countries have undertaken major reforms to prepare themselves for managing and controlling pre-accession funds, particularly those provided through SAPARD. Some bodies are already fit to begin handling EU funds from the beginning of 2001. Others lag behind. Weak areas in many countries continue to be:

- absence of a clearly defined legal base for the mandate and scope of financial control;
- lack of well-designed audit trails providing a foundation for detailed tracking of expenditure on EU funds;
- absence of functionally independent internal audit or inspectorate procedures in line ministries;

- the practice of breaking down the budget into hundreds or thousands of individual appropriations which reduces the ability of line ministries to manage their budgets and weakens financial control;

- problems of recovering losses through administrative actions and an absence of effective anti-fraud co-ordination bodies;

- knowledge and skills that are not appropriate when internal control and internal audit functions are established;

- lack of clarity in understanding the role of the different control functions;

- overlapping controls at the same time as the control is not focused on the areas that are of greatest risk.

Public procurement. The candidate countries are at very different stages of development. One or two countries have laws and procedures that are close to matching those in EU member states. At the other end of the spectrum are countries whose systems are rudimentary and poorly enforced. Few countries have effective central procurement organisations with an adequate mandate and scope of responsibilities. Since procurement is a frequent source of fraud and corruption, and enforcement through control and audit procedures in many countries is weak, resistance to reform may arise. Complaint review systems are often limited to administrative action with no right of appeal to a court as required by EC law. Other weak areas include poorly trained staff in contracting entities, and information systems that are slow, unreliable and fail to take advantage of modern electronic procurement techniques.

External audit. The SAIs of Central and Eastern Europe are taking steps to develop their organisation and working methods. Some countries have worked with SIGMA to arrange a "peer review" which in about half of the cases has been followed by the drafting and implementation of a strategic development plan. However, in many countries, progress has been slow and remaining weaknesses include:

- developing the capacity of the external audit to plan and carry out the full-range of audit types, including financial attestation and performance audits, for all public sector revenues and expenditures including EU funds and resources;

- adopting, adjusting and implementing internationally recognised (INTOSAI) audit standards and the corresponding European implementing guidelines;

- strengthening the SAI's capacity for strategic and operational planning;

- enhancing the SAIs' understanding of a western "control culture" and increasing their knowledge and skills in technical areas of audit;

- improving or putting in place procedures in government and Parliament which ensure audit findings are acted on.

Capacity for reform. In general, the professional quality of staff working in the budget and financial management area – in Ministries of Finance, government control offices, SAIs and procurement offices – is quite high, particularly at the more senior levels**.** However, organisational structures, management controls, information systems and training and staff development programs are usually below western standards. Moreover, the working culture of a centrally planned economy –with the Ministry of Finance operating in effect merely as a "ministry of accounting" – remains strong in many countries. Awareness of western budgetary techniques is increasing rapidly though there are remaining weaknesses. In many countries there is a strong "dynamic for reform" amongst senior officials, but this does not always extend to the political level. Efforts to reform in some countries have frequently been stifled in recent years by the absence of political will, political instability and shifting priorities. In one or two countries in the region (*e.g.* Poland) Ministries of Finance are beginning a process of restructuring that could eventually lead to profound changes in organisational structures, operating systems and procedures and human resource management systems. As noted above, similar changes are occurring in some SAIs and national procurement offices.

2.4. Conclusion

In the mid-1990s, many countries in the region were facing huge stresses on their budgets. In the past few years, considerable progress has been made in bringing fiscal deficits under control, and introducing tighter budgetary procedures. Nevertheless, many problems remain. Countries need to improve their administrative capacity in the areas of budgeting and financial management. Continuing weaknesses in many countries include the absence of a western-style budget and control "culture"; weak organisational and management structures; vertical rather than horizontal decision-making structures; and inappropriate knowledge, skills and analytical capacity in many technical fields. Whether or not these areas are formally part of the EU's *acquis communautaire*, sound budgeting and financial management systems are essential if government programs are to be delivered as cost-effectively as possible.

Making further progress in these areas will require substantial investment in staff development and training, supported in many cases by EU twinning projects and other technical assistance programs. In addition, Parliaments need to strengthen their capacity to analyse budgetary information, so that they can play a full role in balancing the power of the Executive. This should include developing the role of parliamentary committees for budget and public accounts, and strengthening the capacity of the supreme audit institution and its links with the Parliament.

ANNEX
EUROPEAN UNION REGULATIONS CONCERNING FISCAL SURVEILLANCE, BUDGET, FINANCIAL CONTROL AND AUDIT[13]

Primary Law

Number	*Subject*
TEC, Article 10	Establishing general obligations of the member states.
TEC, Article 211	Obligations and responsibilities of the European Commission.
TEC, Article 104	Excessive deficit procedure.
TEC, Article 246-248	Provisions for the European Court of Auditors.
TEC, Articles 268-279	Financial provisions.
TEC, Article 280	Fight against fraud.

** New classification following the Amsterdam Treaty amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts.*

Secondary Law

Fiscal Surveillance

3605/93	Council Regulation of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.
97/C 236/01	Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997.
1467/97	Council Regulation of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
475/2000	Council Regulation of 28 February 2000 amending Regulation (EC) No. 3605/93.

Budgeting

Number	*Subject*
1231/77	Financial Regulation of 21 December 1977 applicable to the general budget of the European Communities.
3418/93	Commission Regulation (Euratom, ECSC, EC) No. 3418/93 of 9 December 1993 laying down detailed rules for the implementation of certain provisions of the Financial Regulation of 21 December 1977.
94/729	Council Decision (EC, Euratom) of 31 October 1994 on budgetary discipline.
Interinstitutional agreement	Budgetary discipline and improvement of the budgetary procedure.

Own resources

88/376	Council Decision (EEC, Euratom) of 24 June 1988 on the system of the Communities' own resources (Implemented by 1552/89).
89/130	Council Directive (EEC, Euratom) of 13 February 1989 on the harmonisation of the compilation of gross domestic product at market prices.
1552/89	Council Regulation (EEC, Euratom) No. 1552/89 of 29 May 1989 implementing Decision 88/376/EEC, Euratom on the system of the Communities' own resources.
1553/89	Council Regulation (EEC, Euratom) No. 1553/89 on the definitive uniform arrangements for the collection of own resources accruing from value added tax.
94/728	Council Decision (EC, Euratom) of 31 October 1994 on the system of the European Communities' own resources.
210/97	Decision No. 210/97/EC of the European Parliament and of the Council of 19 December 1996 adopting an action program for customs in the Community (Customs 2000).

General regulations concerning financial control and external audit

Number	***Subject***
2988/95	Council Regulation (EC, Euratom) No. 2988/95 of 18 December 1995 on the protection of the European Communities financial interests.
2185/96	Council Regulation (Euratom, EC) No. 2185/96 of 11 November 1996. concerning on-the-spot checks and inspections carried out by the Commission in order to protect the European Communities' financial interests against fraud and other irregularities.

Agriculture and fishery

4045/89	Council Regulation (EEC) No. 4045/89 of 21 December 1989 on scrutiny by member states of transactions forming part of the system of financing by the Guarantee Section of the European Agricultural Guidance and Guarantee Fund.
386/90	Council Regulation (EEC) No. 386/90 of 12 February 1990 on the monitoring carried out at the time of export of agricultural products receiving refunds or other amounts.
307/91	Council Regulation (EEC) No. 307/91 of 4 February 1991 on reinforcing the monitoring of certain expenditure chargeable to the Guarantee Section of the European Agricultural Guidance and Guarantee Fund.
3508/92	Council Regulation (EEC) No. 3508/92 of 27 November 1992 establishing an integrated administration and control system (IACS) for certain Community aid schemes (Implemented by 3887/92).
3887/92	Commission Regulation (EEC) No. 3887/92 of 23 December 1992 laying down detailed rules for applying the integrated administration and control system for certain Community aid schemes.
1663/95	Commission Regulation (EC) No. 1663/95 of 7 July 1995 laying down detailed rules for the application of Council Regulation (EEC) No. 729/70 regarding the procedure for the clearance of the accounts of the EAGGF Guarantee Section.
515/97	Council Regulation (EC) No 515/97 of 13 March 1997 on mutual assistance between the administrative authorities of the member states and co-operation between the latter and the Commission to ensure the correct application of the law on customs and agricultural matters.

723/97	Council Regulation (EC) No. 723/97 of 22 April 1997 on the implementation of Member States' action programs on control of EAGGF Guarantee Section expenditure.
1257/1999	Council Regulation (EC) No 1257/1999 of 17 May 1999 on support for rural development from the European Agricultural Guidance and Guarantee Fund (EAGGF) and amending and repealing certain Regulations.
1258/1999	Council Regulation (EC) No 1258/1999 of 17 May 1999 on the financing of the common agricultural policy.
1263/1999	Council Regulation (EC) No 1263/1999 of 21 June 1999 on the Financial Instrument for Fisheries Guidance.

Structural funds

Number	***Subject***
2052/88	Council Regulation (EEC) No. 2052/88 of 24 June 1988 on the tasks of the Structural Funds and their effectiveness and on co-ordination of their activities between themselves and with the operations of the European Investment Bank and the other existing financial instruments (Implemented by 4253/88).
4253/88	Council Regulation (EEC) No. 4253/88 of 19 December 1988 laying down provisions for implementing Regulation (EEC) No. 2052/88 as regards co-ordination of the activities of the different Structural Funds between themselves and with the operations of the European Investment Bank and the other existing financial instruments.
2064/97	Commission Regulation (EC) No. 2064/97 of 15 October 1997 establishing detailed arrangements for the implementation of Council Regulation (EEC) No. 4253/88 as regards the financial control by member states of operations co-financed by the Structural Funds.
1260/1999	Council Regulation (EC) No. 1260/1999 of 21 June 1999 laying down general provisions on the Structural Funds.
1261/1999	Regulation (EC) No. 1261/1999 of the European Parliament and of the Council of 21 June 1999 on the European Regional Development Fund.
1262/1999	Regulation (EC) No. 1262/1999 of the European Parliament and of the Council of 21 June 1999 on the European Social Fund.

Cohesion funds

Number	*Subject*
1164/1994	Council Regulation (EC) No. 1164/94 of 16 May 1994 establishing a Cohesion Fund.
1264/1999	Council Regulation (EC) No 1264/1999 of 21 June 1999 amending Regulation (EC) No 1164/94 establishing a Cohesion Fund.
1265/1999	Council Regulation (EC) No 1265/1999 of 21 June 1999 amending Annex II to Regulation (EC) No 1164/94 establishing a Cohesion Fund.

Pre-accession funds

3906/89	Council Regulation (EEC) No 3906/89 of 18 December 1989 on economic aid to the Republic of Hungary and the Polish People's Republic – with amendments (Phare).
1266/1999	Council Regulation (EC) No 1266/1999 of 21 June 1999 on co-ordinating aid to the applicant countries in the framework of the pre-accession strategy and amending Regulation (EEC) No 3906/89.
1267/1999	Council Regulation (EC) No 1267/1999 of 21 June 1999 establishing an Instrument for Structural Policies for Pre-accession.
1268/1999	Council Regulation (EC) No 1268/1999 of 21 June 1999 on Community support for pre-accession measures for agriculture and rural development in the applicant countries of Central and Eastern Europe in the pre-accession period.

Reclaiming of amounts and sanctions

Number	*Subject*
595/91	Council Regulation (EEC) No. 595/91 of 4 March 1991 concerning irregularities and the recovery of sums wrongly paid in connection with the financing of the common agricultural policy and the organisation of an information system in this field.
1681/94	Commission Regulation (EC) No. 1681/94 of 11 July 1994 concerning irregularities and the recovery of sums wrongly paid in connection with the financing of the structural policies and the organisation of an information system in this field.

1469/95	Council Regulation (EC) No. 1469/95 of 22 June 1995 on measures to be taken with regard to certain beneficiaries of operations financed by the Guarantee Section of the EAGGF.
745/96	Commission Regulation (EC) No. 745/96 of 24 April 1996 laying down detailed rules for the application of Council Regulation (EC) No. 1469/95 on measures to be taken with regard to certain beneficiaries of operations financed by the Guarantee Section of the EAGGF.

Anti-fraud and anti-corruption regulations

Number	***Subject***
Decision	Commission Decision of 28 April 1999 establishing the European Anti-Fraud Office (OLAF) (notified under document number SEC(1999) 802) (1999/352/EC, ECSC, Euratom).
Agreement	Interinstitutional Agreement of 25 May 1999 between the European Parliament, the Council of the European Union and the Commission of the European Communities concerning internal investigations by the European Anti-Fraud Office (OLAF).
1073/1999	Regulation (EC) No 1073/1999 of the European Parliament and of the Council of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF).
1074/1999	Council Regulation (EURATOM) No 1074/1999 of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF).

NOTES

1. Bulgaria, Estonia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. In addition to these 10 countries from Central and Eastern Europe, Cyprus, Malta and Turkey are also candidates for EU membership.

2. SIGMA – Support for Improvement in Governance and Management in Central and Eastern European Countries – is a joint initiative of the OECD and the European Union. The initiative supports public administration reform efforts in 13 countries in transition, and is principally financed by the EU Phare Program.

3. See *Effects of European Accession, Part 1: Budgeting and Financial Control*; and *Part 2: External Audit*, SIGMA Papers Nos. 19 and 20, SIGMA/OECD, Paris, 1997. The seven countries reviewed were Austria, Denmark, Finland, France, Portugal, Sweden and the United Kingdom.

4. Kjell Larsson and Richard Allen, "The Impact of EU Accession on Budgeting, Control and Audit" in *Preparing Public Administrations for the European Administrative Space*, SIGMA Paper No. 23, SIGMA/OECD, Paris, 1998.

5. There are three such aid programs: SAPARD (Special Accession Program for Agriculture and Rural Development), ISPA (Instrument for Structural Policies for Pre-Accession), and Phare. These programs are substantial: in the case of SAPARD, for example, the EU has earmarked 3.5 billion Euros over seven years for the 10 candidate countries in Central and Eastern Europe.

6. The scale is as follows: baseline not achieved (1); baseline partially achieved (2); baseline substantially achieved (3); baseline achieved (4).

7. In fact, the baseline measures described in Paragraphs 56-70 summarise the four sets of baselines prepared by SIGMA within a single set. The sections on financial control, public procurement and external audit (see Part II B) are a compressed version of the original baselines.

8. The European System of Accounts (1995) promulgated by the European Statistics Office (EUROSTAT).

9. If an acceptable standard is defined as an average score of 3, only one country achieved this standard in the year 2000 on public expenditure management, none on financial control, one on public procurement and two on external audit.

10. Hungary was the first of the Central and Eastern European countries to set up a modern, fully computerised Treasury system. The Treasury was established in 1995 and within nine months employed 200 people and was fully operational. The organisation employs 900 staff, 400 of whom work in the Budapest headquarters and 500 in the branch networks (comprising 18 county offices). The Treasury performs activities in several areas: operating a bank clearing and settlement function for the central budget; carrying out appropriations and making related payments; administering the single Treasury account; operating the treasury accounting system; providing essential financial information to the Ministry of Finance; carrying out similar clearing, settlement and appropriations functions on behalf of line ministries and other government bodies; financing central government activities including fixed investment projects; and managing the state debt and organising the issue and sale of government securities. A high proportion of staff time is devoted to preparing for further expansion of Treasury activities, to training staff and creating an integrated professional community.

11. This is a mechanism set up by member states, under EU regulations, for managing and controlling EU funds. The National Fund is usually located in or attached to the State Treasury. The European Commission developed the National Fund concept for the decentralised implementation of EU assistance in all candidate countries. The introduction of the National Fund system requires the strengthening within national administrations of procedures for public expenditure management, in particular internal control and internal audit functions. Accounting and public procurement systems also need upgrading in order to comply with EU regulations and standards.

12. GFS = Government Finance Statistics (IMF, revised 2000); COFOG = Classification of Functions of the Government (UN, 1999).

13. Based on Annex III of Richard Allen and Daniel Tommasi (eds.) *Managing Public Expenditure: A Reference Book for Transition Countries*, OECD, 2001.

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN THE UNITED KINGDOM

BY
NOEL HEPWORTH*

1. Introduction

Developments in public sector accounting and budgeting in the United Kingdom should be related to many other reforms that have occurred within the United Kingdom public sector. It is equally important to relate reforms of the management of United Kingdom public services to other trends in United Kingdom society and also in the economy of the country. Only by looking at this wider background is it possible to fully understand what has occurred and why.

Therefore the first part of this paper will include a very brief overview of these trends and reforms. Many of the reforms to the management of the public services are essential components in causing the accounting and budgeting changes to have value. In the United Kingdom context at least, reform to the accounting and budgeting processes would have been at best of limited value without being accompanied by, or preceded by, a range of other reforms.

The second part of the paper will describe the reforms to the central governments' accounting and budgeting processes, focusing on a system called "resource accounting and budgeting" (or RAB), and will explore some of the issues that have been raised by Parliament and setting out the managerial and institutional arrangements that are needed to parallel these reforms.

The paper will conclude by identifying the preconditions for introducing resource accounting and budgeting and will offer some lessons for other countries considering adopting accrual accounting in their public sector.

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1.1. The UK public sector

The United Kingdom public sector is diverse and includes:[1]

- local governments: which cover both urban and rural areas and are now financed largely by central government, and which to a degree have a democratic mandate independent of the central government;

- government-controlled trading entities: though many fewer than historically and rapidly being privatised;

- hospitals and other related organisations responsible for the management of health care: controlled and financed by the central government but operating to a considerable degree independently of the central government;

- agencies controlled by the central government with a degree of managerial autonomy but largely financed by central government;

- central government departments directly under the control of a minister of the government of the day, including the armed forces.

The public sector accounts for about 40% of the United Kingdom gross domestic product (GDP). At one stage in the mid-1970s this proportion had risen to about 50%. Despite the attempts of some United Kingdom governments, it has been very difficult to reduce the proportion below present levels.

1.2. Public financial management system

Accounting officers. The United Kingdom operates a unified system of management. An official is the designated "accounting officer"[2] in central government and there is an equivalent in other parts of the public sector. The "accounting officer" is responsible for both operational and service management, and for all aspects of finance and accounting that is relevant to the management of the service. In other parts of the public sector, the equivalent to the "accounting officer" may be a subordinate official and not the most senior official. Where this arrangement occurs, the ultimate responsibility for the financial arrangements and the management arrangements remains with the more senior official. This is unlike, for example, some European countries where there can be separate management and financial control hierarchies.

Management accountability. An essential requirement of good public sector management, especially in the development and use of accrual accounting and budgetary information, is that the manager has a comprehensive responsibility. If the manager does not have that comprehensive responsibility, there is not the same incentive to ensure that the accounting system produces the information required. As a result "private", unregulated and idiosyncratic information systems tend to develop.

Departments also have considerable operational responsibilities without the need to defer to central decisions and this is an aspect of resource accounting. Thus, for example, where the resource accounting rules specify that assets have to be valued and depreciated, the way in which valuations are arrived at in practice and the periods for depreciation are left to the judgement of departments.

1.3. Contemporary reform in perspective

Time period. This paper considers a period of at least 30 years. Even prior to that a wide-range of experimental reforms – although they would not have been described as experimental at the time – occurred that sought to challenge established orthodoxy. Even the reforms concerned solely with accounting and budgeting have taken about 10 years to introduce, and there is no evidence at all that the process of reform has by any means been completed. In the United Kingdom we are merely at a particular stage in an ongoing process of reform. That it is a process is an important point to recognise. Politicians, management and staff do not therefore see that they have somehow arrived at a finality; rather the conditioned thinking is that they do regard the whole reform process as ongoing. Therefore, the expectation is that further changes are likely to occur.

The main drivers of reform. The main drivers of these reforms have been economic, with the demands for public sector services and investment being increasingly difficult to finance, especially in inflationary conditions. Political pressure to reduce levels of direct taxation has added to the financing problem, as have changes in public attitudes and wealth, and a change in culture from a producer lead society to a consumer driven society. Overlying these pressures has been a general desire to improve the efficiency and effectiveness of the total public sector.

These drivers have in turn lead to substantial changes in the structures, functions, control and distribution of public sector activities. They have also resulted in changes in attitudes to audit and to the development of a wide-range of regulatory and inspection regimes and organisations. Professional advice on which government often heavily relied, has increasingly been subject to challenge. In its turn the professions which traditionally have largely operated on a self-regulatory basis independent of government, have themselves become subject to regulation.

However it is fair to say that future reforms to the management of public sector services and institutions, are likely to build on a key feature of the recent changes, that is the introduction of accrual accounting and budgeting. We will see both technical and managerial improvements in the way in which accrual accounting and budgeting is developed and used. We will not see the abandonment of this reform and a reversion to cash forms of accounting.

Local government and nationalised industries. This introduction of accrual accounting did not start with central government. Indeed the central government is actually the last area of public sector activity to see the introduction of accrual accounting. Local government had for many years operated a system of partial accrual accounting and budgeting (the main deficiency was in the area of capital accounting and the treatment of stocks, although in the early 1990s this was remedied at the initiative of the accountancy profession). The former nationalised industries used full accrual accounting, and more latterly the health service introduced accrual accounting. (The central government when it introduced this reform decided not to use the term accrual accounting, but used "resource accounting" instead.) Even though the central government was the last part of the public sector to introduce accrual accounting this paper will focus on this development as being the most relevant and informative.

2. Public sector management before the RAB

2.1. The large role of government

The present processes of reform had their origins in the recovery of the United Kingdom from the consequences of World War II which caused considerable damage to both the infrastructure and to the economy. No new capital investment had occurred in that period. In addition, social attitudes had changed and there was a considerable demand for improvements to the public services and for better health and social security arrangements. The private sector would not have been able to meet these demands, although that would not have been a politically acceptable solution at that time. The result was a very substantial expansion both of the role, range of activities and scale of the public sector. At the same time inflation emerged as a problem, levels of taxation and public sector borrowing rose to unsustainable levels. Whilst GDP per head continued to rise, the relative overall economic position of the United Kingdom, from being a very rich nation, began to decline.

2.2. Past reforms: PPBS

The pressure therefore emerged for better planning of public expenditure generally coupled with a demand for improved management of the public services. Various experiments occurred usually not well co-ordinated within the different parts of the public sector. Local government, for example, experimented with Planning Programming Budgeting Systems (PPBS). This collapsed because of the cost and complexity of the system and, in the end, the arbitrary decisions that were required. Other derivatives of PPBS were experimented with such as management by objectives and performance measurement. Again, often their failures were rooted in a lack of technical research, complexity, the difficulties of avoiding mechanistic reviews and an inadequate emphasis on training. They also became overwhelmed by other priorities often resulting from external events over which local government had no control such as the overall state of the United Kingdom economy.

2.3. Comprehensive public expenditure survey in the 1960s

The central government during the 1960s introduced a comprehensive public expenditure survey system. Long-term strategic planning coupled with financial programming for three to four years ahead was developed with a firm budget plan for the immediate year ahead. Subsequently a review process was initiated to examine whether it was necessary for activities to be carried out by the government sector. This process had a number of weaknesses. The ambitions for a comprehensive rational planning system were not realised because those plans were over ambitious and political decisions were not always compatible with a managerially rational planning process. Programming exercises also tended to become mechanistic. A Keynesian approach to planning in inflation-adjusted resource terms proved impractical when inflation accelerated and it weakened financial control over key elements of expenditure, such as pay.

2.4. Cost controls in the 1970s

The early 1970s oil crisis produced a severe shock to the United Kingdom economy and the emphasis of expenditure control switched to cash. Firm cash limits were introduced and there was an emphasis on efficiency gains with an added pressure to eliminate unnecessary activities from government. Subsequent reforms, some of which were brought in through a change of government, introduced greater controls over spending. Those ministers and officials who did not embrace the new approach were replaced. Greater emphasis was placed on the management role of ministers and senior civil servants in controlling costs. This management role was no longer to be subordinated to the traditional policy-making and advisory role. A much tighter cost control regime was introduced with a new drive for increased efficiency and effectiveness. As part of this, a need for greater delegation of responsibility was accepted but this was to be accompanied by new arrangements to improve accountability for performance.

2.5. New Public Management

The central government was in effect moving to was the introduction of key features of what has become known as “New Public Management”. These key features included:

- the separation of policy-making from service delivery and the creation of agencies to deliver services;
- rewards for good performance in achieving set objectives;
- a shift in emphasis to outputs and outcomes from inputs;
- the development of extensive ranges of performance measures and indicators;
- development of arrangements for the systematic comparison of activities between management units (benchmarking);
- a separation of the provider function and producer function with the creation of administrative markets to promote competition between the different producer organisations; this lead in turn to,

- an increased emphasis on a review of what the public sector should be undertaking with non-core and “producer” activities being shifted to the private sector (privatisation); and

- the introduction of compulsory competitive testing (sometimes called market testing); and

- a stricter value-for-money audit regime and where appropriate inspection and regulatory arrangements.

2.6. Other new approaches

Subsequent reforms have developed further new approaches to managing public expenditure. These included:

- the development of public/private partnerships (including the “private finance initiative”) intended to facilitate the finance of public infrastructure by shifting the risk of provision and operation partly or wholly to the private sector;

- new arrangements for the control of public capital expenditure (borrowing only to finance investment (the “golden rule”), with debt to be maintained as a steady and sustainable ratio to GDP); and

- the introduction of a low inflation economic policy resulting in the government giving independence to the central bank with responsibility for determining interest rates to sustain that low inflation policy.

The development of resource accounting and budgeting has only occurred towards the end of this very long process of reform. It was not a precursor to these other reforms. Yet it was an essential feature to ensure that comprehensive and reliable information was available to decision-makers. It resulted in a greater cohesion between information required for economic management purposes and that required for budget allocation and service management decisions. It was also essential to ensure that comparisons could properly be made between private and public sector activities. Without that, the development in any systematic way of competitive tendering between the public and private sectors would not have been possible and neither would public/private partnerships.

3. Resource accounting and budgeting

3.1. Basic definition of RAB

An initial announcement about the introduction of resource accounting was made in the November 1993 Budget Statement by the Chancellor of the Exchequer (Minister of Finance). Prior to that, a consultation exercise involving all central government departments had been undertaken.

In July 1994 a public consultation paper was issued "Better Accounting for the Taxpayers' Money: Resource Accounting and Budgeting in Government".[3] This consultation paper described the main features of resource accounting and budgeting, the expected benefits and the timetable, as well as the process of consultation. It defined resource accounting and budgeting as follows:

> *The term "resource accounting" covers a set of accrual accounting techniques for reporting on the expenditure of United Kingdom central government, comprising departments and their executive agencies including Trading Funds (the departmental boundary), and a framework for analysing expenditure by departmental objective, relating this to outputs wherever possible. "Resource budgeting" covers planning and controlling public expenditure on a resource accounting basis.*

3.2. Harmonisation with business accounting

The government recommended, following on from this definition, that the framework of accounting principles and conventions for resource accounting in departments should be based on United Kingdom Generally Accepted Accounting Practice (United Kingdom GAAP), in particular the accounting and disclosure requirements of the Companies Act 1985 (which applies to private sector companies) and accounting standards, adapted to meet the particular requirements of central government and parliamentary control. The aim was to ensure broad consistency with accounting practice in the rest of the public sector and the private sector. It was further proposed that one consolidated set of resource accounts should be prepared by each department. This would include the assets and liabilities of its executive agencies including Trading Funds. The audit opinion to be attached to the published financial statements would be a "true and fair" view opinion. The audit opinion on the cash-based accounts was "properly presents".

The context for the proposed change was set out in an introductory comment by the Chancellor, *i.e.*:

> *The government is committed to a continuing program of radical improvement in the way the public sector manages itself. Only by taking a progressively more business-like approach can the government continue to bear down on the cost to the taxpayer of delivering public services whilst improving service standards….*
>
> *The changes described in this paper are a major undertaking – probably the most important reform of civil service accounting and budgeting arrangements this century..…The proposals are firmly based on improvements in accountancy practice and financial control that have taken place decades ago in most other large organisations. To implement the changes successfully will require the development of new skills, and commitment and leadership from managers at all levels in the civil service.*

Resource accounting was intended to allow managers in departments to evaluate the cost of using capital and current resources on an equivalent basis. It was expected to strengthen cash management in departments and to provide a much better means for setting departmental objectives and outputs in terms of resources used.

3.3. Anticipated benefits of RAB

The overall benefits that were foreseen for the reform were summarised in the Consultation Paper:

- benefits for government departments:
  - more accurate and relevant management information with which departments can cost the resources that they use, decide in the mix of resources they need with the outputs they deliver; and
  - better informed decisions on the balance between current and capital expenditure, taking into account the opportunity cost of capital and its consumption over time.
- benefits for across government:
  - provide a better basis for the treatment of capital;

- encourage improved use of capital by creating an opportunity to develop a more systematic approach to capital charging; and

- make comparisons of services provided across the public sector and with the private sector more straightforward.

- benefits for the public sector as a whole:

    - improvements in the way in which government conducts its public expenditure planning and control procedures at all levels;

    - facilitating the development of cash control at a higher level than hitherto, whilst keeping tight control of public spending as a whole; and

    - in line with other initiatives, contributing to the further development of a strategic approach to managing the civil service, in line with the principles of the Financial Management Initiative.[4]

- benefits for the economy:

    - better information for formulating economic policy and preparing National Accounts on the value and use of fixed assets and capital consumption in the public sector;

    - the possibility of a reduction in the public sector's call on funds by promoting better use of resources;

    - the possibility of reduced borrowing through identifying, and then disposing of, under-utilised fixed assets, and through the better management of working capital; and

    - there would also be a range of statistical benefits as well.

So far as resource budgeting was concerned, one of the consequences of its introduction was that it would change the public expenditure control total to an accruals basis. This would be consistent with the measurement definition of Gross Domestic Product (GDP). However, one point of concern was that a switch to resource budgeting might risk some loss of control over cash and therefore the move to resource budgeting was to be accompanied by continuing firm control over cash. Cash control though could be exercised at a less detailed level.

Advantages of Resource Budgeting

The advantages of resource budgeting were identified as:

- a better informed process of planning public expenditure, for government as a whole and for departments individually;

- pressure for spending at the end of the financial year (the "year-end surge") would be reduced (a particularly important benefit in the management of expenditure and cash and in improving efficiency);

- control of expenditure would be more soundly based, since managers would have more relevant information;

- the procedures for deciding on the level of capital would be improved and there would be a more rational basis for the treatment of capital;

- providing for better informed policy choices between spending options;

- allow for more effective organisation and planning of the relationship between departments, their executive agencies and the other bodies (such as non-departmental public bodies (NDPBs));

- encourage departments to focus on the services and other outputs which they deliver, rather than on the inputs which they consume; and

- allow departments to plan internally and be controlled externally on the same basis.

At the parliamentary level, the Consultation Paper envisaged that it would be possible to continue to seek parliamentary authority and report back on the present cash basis, with a different resource-based budgeting system within government. This would potentially be a more complicated system. One outcome of the consultation process was that this would be changed and there would in future be two expenditure control totals, one cash and one resources.

3.4. Outputs of RAB

The resource accounting and budgeting system will produce financial statements for both departments and the central government as a whole. These are briefly described.

Department financial statements. The financial statements emerging from the resource accounts would be based on the standard commercial model of profit and loss account and balance sheet. However, the resource account formats would differ from company formats in a number of respects to reflect the context and nature of central government. In addition, changes were necessary to enable the financial information in resource accounts to be compared with departments' resource based estimates.

The financial statements to be published comprise the following:

- Schedule 1: Summary of Resource Outturn: the parliamentary control schedule comparing outturn with estimate for both resource expenditure and the overall cash requirement;

- Schedule 2: *i)* Operating Cost Statement: showing resources consumed during the year in support of both the department's own administration expenditure and its program expenditure, net of departmental income; *ii)* Statement of Recognised Gains and Losses;

- Schedule 3: Balance Sheet: showing the assets and liabilities at the year end, which are represented by taxpayers' equity;

- Schedule 4: Cash Flow Statement: analysing the net cash flow by headings, including operating activities, capital expenditure and financing;

- Schedule 5: Resources by Departmental Aim and Objectives: analysed by aim and objectives; and

- Notes to the accounts: explaining and amplifying the information in the previous schedules.

There is a complementary output and performance analysis statement and accompanying report. These do not form part of the annual report and accounts but, where appropriate, financial information they contain is based on the accounts.

Whole-of-government Accounts (WGA). A decision has now been made to publish a set of "whole-of-government accounts".[5] This would cover government defined in the widest sense, that is covering the whole of the public sector, although no final decisions have yet been taken on what will fall within the WGA. The same accounting principles as underlie resource accounting will be used.

The aim is to provide better quality data to underpin the "golden rule" (*i.e.* that government borrowing should be for capital investment purposes only) and to provide a public sector balance sheet that could be used more directly in fiscal management. The benefits are intended to lie in improvement on policy-making in the setting of a prudent fiscal stance, reforming policy-making from short- to long-term and a more efficient distribution of resources. There would also be increased consistency between fiscal policy data and that used for planning and controlling public expenditure.

Because the whole of the public sector has adopted accrual accounting on broadly (but not wholly) the same basis, this should facilitate the development of whole-of-government accounts. The main practical difficulty is perceived to be the elimination of intra public sector transactions and balances. However, there are major policy issues that will need to be addressed, such as the method of accounting for taxation revenue and for long-term liabilities such as social insurance and pensions.

The target is to produce whole-of-government accounts for the financial year 2005-06.

3.5. UK GAAP

As resource accounting is based on United Kingdom Generally Accepted Accounting Practice (GAAP) and on the accounting and disclosure requirements of the Companies Act (1985) and accounting standards, these need to be supplemented, where appropriate, to take account of the public sector context.

Underlying concepts and specific applications. United Kingdom GAAP is underpinned by five accounting concepts, all of which would apply to resource accounting. These are briefly described in Table 1.

How these concepts would be applied for particular items is described in Annex 1.

Table 1. **Five underlying accounting concepts**

Concepts	Definitions
Materiality	• Strict compliance with United Kingdom GAAP would not necessarily apply where the amounts involved are not material to a true and fair presentation of the financial results and position.
Going concern	• Accounts would be prepared on the basis that the department or other public sector entity will continue to operate for the foreseeable future.
Matching/ accruals	• Income and expenditure would be matched to the services provided or consumed in the same accounting period.
Consistency	• Accounting policies would be consistently applied, both within and between each accounting period. Policies would only be changed on the grounds that the new policy gives a fairer presentation of the transactions and of the financial position.
Prudence	• Proper allowance would be made for all known and foreseeable losses and liabilities; income would only be included where there is a reasonable certainty of it arising.

The Financial Reporting Advisory Board to the Treasury. The Financial Reporting Advisory Board (FRAB) was established in 1996 with the aim of ensuring that resource accounts meet the best possible standards of financial reporting by following United Kingdom GAAP as far as possible. Its initial task was to advise the Treasury on the application of financial reporting principles and standards contained in the Resource Accounting Manual, which was used as the basis for departmental resource accounts. In establishing the board, the Treasury undertook to forward to Parliament "a report on the board's activities, setting out the resource accounting policies to be adopted and subsequent material changes, together with the views of the board".

The board is chaired by an independent person and includes members who are fully independent of the Treasury and one (not the chairman) who is a member of the staff of the Comptroller and Auditor General. Other members include representatives from the Audit Commission (which audits local government and health organisations), the Accounting Standards Board, industry and academia. The Treasury set out the reporting standards to be adopted and publish them to departments in the Resource Accounting Manual. The purpose of the board is to introduce an independent element into the process of setting their financial reporting standards and it has to be consulted on all additions and changes, including proposals not to follow standard practice.

The technical issues dealt with by the board in its third report issued in June 2000 covered:[6]

- the definition of the departmental boundary;
- the interaction between resource accounting and resource budgeting;
- accounting for the effects of general inflation;
- the valuation of heritage assets;
- disclosure of information about salaries and pensions;
- the quality of explanation accredited with the "Operating Cost Statement";
- accounting arrangements under the "Private Finance Initiative";
- the form and content of pension scheme statements;
- the arrangement for the accounting for student loans;
- statement on the systems of internal financial control;
- provisions for the liabilities of non-departmental public bodies (NDPBs);
- disclosure of prejudicial information affecting a department's negotiating power;
- tangible fixed assets;
- mergers and the transfer of functions;
- the transfer of fixed assets between departments;
- the treatment of prior period adjustments;
- increasing the compatibility of resource accounts and national accounts balance sheet data;

- revision of the accounting guidance for executive NDPBs and Trading Fund guidance.

A dynamic process. The introduction of resource accounting is a dynamic process. The list of issues considered in the third report of FRAB indicates a continuous process of development. This process of development is driven by a number of factors, such as:

- GAAP itself is dynamic and is constantly being developed by the issue of new statements of practice and by modifications to existing practice;

- GAAP is affected by developments in standard setting at an international level and this too is a dynamic process;

- the practical experience of resource accounting still requires modifications to be introduced;

- new developments in government activity also require that changes be made.

Therefore, both the Treasury, the departments, the external auditor and Parliament need to have the capacity to recognise the need for change, to have the technical ability to respond to change and to have the operational capacity to introduce changes as they emerge. This means that a system of regular updates has to be available, which involves a systematic discussion process within government with, at least so far, annual editions of the Resource Accounting Manual being published to ensure that the whole process is properly documented and understood. One major new issue that has emerged since the publication of the original Consultation Paper is that of the desirability of publishing "whole-of-government accounts".

3.6. Timetable

The announced timetable for consultation and implementation resource accounting and budgeting was:

- to implement resource accounting in the majority of departments by 1 April 1997 and in all departments by 1 April 1998;

- that the first year in which resource accounts were to be published and laid before Parliament would be 1999-2000;

- in principle, to introduce resource budgeting across government;

- to consult on how a resource-based Public Expenditure Survey would work in practice;

- that, subject to meeting the target dates above for introducing resource accounting, and the results of further consultation, the first Survey on a resource basis would be carried out in the year 2000;

- to consult Parliament and others on how expenditure might be controlled on a resource basis and on the consequent reporting arrangements; and

- that the consultation period would last until 31 January 1995. The government would then publish its detailed proposals for resource budgeting, and the implications for Parliament, as soon as possible thereafter.

The experience in the United Kingdom is that frequently the timetables for such innovative reforms tend to slip. However, in the event, this has not occurred.

4. Issues and concerns

4.1. Issues and government responses

In July 1995, the government published its response to the Consultation Paper.[7] This response summarised the main comments, which were generally supportive, and the government's decision in response to the comments. The main issues raised were:

The departmental boundary. There were differing views of the criteria that should apply to determine the departmental boundary for consolidation purposes. Some supported the view that the boundary should reflect the principal accounting officer's legal responsibilities, instead of drawn more widely to reflect *de facto* control. These respondents also believed that a department's NDPBs (non-departmental public bodies) should be considered. The decision by the government was that consolidation would depend upon the operating circumstances of that NDPB, although the presumption would be that the NDPB should lie outside the departmental boundary.

Timetable. There was no consensus on the proposed implementation timetable. The decision by the government was to retain the original timetable.

Standard setting. Several respondents saw a need for external involvement, especially a role for the public sector sub-group of the Accounting Standards Board. This was an important issue in terms of securing independence in the development of or the application of United Kingdom accountancy principles. The government decided, therefore, to establish the Financial Reporting Advisory Board (FRAB).

Asset valuation principles. There was some disagreement with the proposal to apply the modified historic cost methodology for valuation of assets, which does not reflect current practice within the private sector.

Military assets. The government agreed with the majority view that military assets should be capitalised and depreciated, and decided to treat them in the same manner as other tangible fixed assets.

Infrastructure assets. Respondents supported the capitalisation of infrastructure assets with various views on the basis of valuation ranging from modern equivalent to historical cost, depending on the treatment of maintenance. The government decided that infrastructure assets should be valued every five years on the basis of current replacement cost depreciated to reflect the condition of the network.

Heritage assets. Whilst there was general agreement that the heritage attributes of assets should not be valued, some respondents agreed that a value should be attributed to operational elements. Heritage assets would be treated as follows: *(a)* operational heritage assets would be capitalised; *(b)* non-operational heritage assets would only be capitalised where the benefits of valuation outweigh the costs of valuation, and the asset is capable of reliable measurement; and *(c)* newly purchased non-operational heritage assets would be capitalised in future (since the purchase cost is a reasonable proxy for valuation), even though the main heritage arts collections have not been capitalised.

Pension liabilities. In response to the issue of whether civil service pensions would be included as a deferred liability, the government decided to charge pension costs to a department’s expenses in the year in which they arise.

Capital charging. There was no consensus on this or on whether such a charge should be notional or in cash. The government decided that departments should be charged for the cost of capital employed, to include both fixed assets and working capital.

4.2. Criticisms from other than parliamentary

A number of criticisms have been made of the reform and these have been recently summarised and commented upon by Likierman[8] who is the current Head of the United Kingdom Government Accounting Service. The issues are identified below:

1. Whether the change is worthwhile. Subsidiary issues related to *(a)* basing the RAB framework on private sector accounting practice, and the possibility of creative accounting; *(b)* whether it is necessary to have a comprehensive new framework for government.

2. Whether the new budgeting system will work in practice, bearing in mind all the new information required on accruals and performance.

3. Concern about potential misunderstandings and misuse of cost-based information.

4. Questions about the new asset system, especially calculating depreciation and the impact of capital charging on decision-making.

5. Questions on the feasibility of constructing meaningful output and performance information, and whether this information will be ignored or misused.

6. Whether the RAB initiative will be too narrowly interpreted and/or implemented to fulfil its potential.

A number of general themes are evident in these arguments. Three of them are singled out for further analysis.

Is change desirable? This question carries the implicit premise that the present methods are adequate. Yet it is clear from the process of change that a good deal of the effort has been to bring systems and knowledge to a level of expertise which many should already have had. Furthermore, it would be surprising if cash alone is better than using a combination of cost and cash. Similarly, linking outputs and outcomes to use of resources must be preferable to using input measures alone. After all, the main objective of government policy is to deliver better services, not to spend more cash.

Will change happen? There is bipartisan support for resource accounting and budgeting. In 1997 the Labour Administration reinforced the initiative started by the Conservative Government by: *(a)* including the focus on output and outcome measures; *(b)* the compilation of National Asset Registers; and *(c)* the direct links to a new macro-economic framework. There are additional reinforcements from the importance of the processes of budgeting and control to departments, where there have been very public commitments to change.

Will information be misused? As much of the new information is only now becoming available, it is still too early to make judgements on how it will be used. But the concern assumes a great deal of naivety by those involved. Some misuse of any information is common, learning will need time and it would be wrong to be complacent. But bearing in mind the commitment, including to training, the lead-time for the project and the transparency of transactions, there is no reason to assume the worst. As with all new frameworks of this kind, the onus is on those who set it up to ensure that they do not provide inappropriate signals. A great deal of work has been undertaken to provide safeguards in budgeting, control and reporting. The two-stage introduction of resource budgeting is one such example.

4.3. Parliamentary concerns

The whole process of introducing resource accounting and budgeting has been subject to parliamentary scrutiny, primarily by the Public Accounts Committee (PAC). This powerful committee, chaired by a senior member of the Opposition, has as its principal responsibility the scrutiny of government activity to ensure that money is both properly spent and spent efficiently and effectively. The committee is supported by the work of the Comptroller and Auditor General, who is the government external auditor and head of the National Audit Office (NAO).

The Concerns of the Public Accounts Committee are reflected in its specific questions addressed to the government.

1. Will the principles and procedures of supply[9] be maintained under RAB?

2. Will parliamentary control be diminished because more judgements and estimates are required in RAB?

3. Will there be less parliamentary control if only net expenditure – in cash terms – is being controlled?

4. Would cash and/or resources be voted and how would dual voting be reconciled?

5. At what level of detail in the resource-based estimates will parliamentary voting and authority apply?

6. Will capital be presented and voted in gross or net amounts in the resource-based estimates?

7. Will there be a forecast balance to support resource-based estimates?

8. Will departments be able to take advantage of "creative accounting"?

The answers from the Treasury to these questions are reproduced in Annex 2.

4.4. Implementation concerns

The Public Accounts Committee was also concerned about the process of moving from a cash to a resource-based system of accounting. These implementation concerns included: *i)* how robust the timetable for the change was; *ii)* whether it was desirable to maintain two sets of accounts, one cash and one accrual, for a lengthy period; and *iii)* how estimates could be compared with what actually was spent in a financial year. The Treasury's responses to the Public Accounts Committee[10] are summarised below.

Timetable. The PAC's main concerns were: *(a)* the quality of the data that will appear in the first resource-based estimates for 2001-02; and *(b)* that Parliament will be asked to approve the first resource-based Vote on Account for 2001-02 in the autumn of 2000, at broadly the same time that the first full set of audited Resource Accounts is presented to Parliament.

To provide evidence that the program for implementation remained in accordance with the timetable, three "trigger" points were identified (with completion dates in brackets):

- "Stage 1 approval" (April-December 1998);
- assessment of departments' opening balance sheets for 1999-2000 (April-June 1999); and

- NAO's audit of departments' experimental run 1998-99 Resource Accounts (Autumn 1999).

The Treasury and the NAO were both to monitor departments' performances carefully against the trigger points. The Treasury would report back to Parliament on progress in achieving them. The Treasury believed that this arrangement would provide the necessary reassurances to Parliament.

The Public Accounts Committee was concerned about what would happen if the trigger points were not successfully passed. The Treasury response was that, as each trigger point is reached, it would take a view on the overall position of departments and determine future action in the light of that. Furthermore, the trigger points were not however the only points at which the monitoring of implementation would occur. Both the Treasury and the NAO had in place a continuing process of monitoring individual departments' progress. Regular bilateral meetings took place between the Treasury and the NAO to discuss implementation, so that any emerging problems could be identified at an early stage and dealt with as they arose. The trigger points were therefore intended to act as specific occasions on which to review the overall position, and against which progress in implementation could be reported back to the Parliamentary Committees.

The second trigger point – an assessment of departments' opening balance sheets for 1999-2000 – was included for two main reasons. First, it represented a useful mid-point at which to take stock of progress between "Stage 1 approval" in 1998 and full audit by the NAO of departments' dry run 1998-99 Resource Accounts in the autumn of 1999. Second, a view of departments' opening balance sheets for 1999-2000 at that stage would both provide timely information and be revealing in itself. The key factors in assessing progress at the second trigger point stage would be the quality of the balance sheet information, which inevitably involved a degree of subjective judgement, and consistency with the policies set out in the Resource Accounting Manual.

Two sets of accounts. The PAC sought information about: *(a)* the overall cost of introducing the new resource accounting and budgeting system; *(b)* the cost of "double-running" already planned to extending over three years from 1998 to 2001; *(c)* and the cost of extending "double-running" for a further year.

The Treasury believed that since the resource accounting and budgeting project extended over eight years, estimates of its costs would be extremely unreliable. Furthermore, the costs directly attributable to introducing resource accounting systems were not separately distinguishable. It was also extremely difficult to quantify other costs associated with the project, such as management time. The estimated costs of extending double running for a further year varied considerably from department to department depending on a number of factors, including the method of implementing the new system, the size and complexity of individual departments and the nature of their business. Overall though, the total cost of extending "double running" for an additional year was estimated by departments to range between £15-20 million.

Comparison between estimates and resource-based accounts. A concern was expressed by Parliament about the possibility of comparing departmental resource accounts statements of expenditure and the detailed amounts contained in the estimates. The Treasury argued that it would be possible to make a detailed comparison of the expenditure of resources by subhead with the corresponding amounts shown in the resource estimates.

In response to the question about whether resource-based estimates would include figures for gross expenditure, the Treasury's answer was that resource-based estimates would show gross expenditure within the resource budget, broken down between administration costs, other revenue expenditure and grants. Alongside the gross expenditure figures, the estimate would also provide a breakdown of resource budget appropriations in aid[11] and the net resource requirement.

4.5. Conclusions of the Public Accounts Committee[12]

The PAC supported the switch to resource accounting, which it believed would improve the clarity and quality of financial information available to Parliament. However, it took the view that the cash-based system should not be dispensed with until Parliament was satisfied that the resource accounting system provided the same levels of accountability and assurance as the cash-based system. Its conclusions and recommendations were:

- The Treasury should be allowed to proceed towards implementing resource-based supply from 2001-02 and, at the same time, replace appropriation accounts[13] with resource accounts.

- There remain a number of risks to be addressed if the project is to be implemented successfully, in particular for those departments that have yet to demonstrate their ability to prepare reliable resource accounts. We shall look to the Treasury to ensure that the safeguards proposed to address these risks are applied rigorously, and that the risks are managed so as to ensure that accountability to Parliament is fully maintained under the new system from 2001-02.

- Whilst the new supply mechanisms appear to offer at least a comparable degree of control for Parliament, only once they are operational will all their effects become fully apparent.

- In addition to his regular audit of each account, we shall look to the Comptroller and Auditor General to draw to our attention any features of uses of the new system that appear to prejudice that control and to provide assurance that the interests of Parliament are being protected.

The committee's more specific conclusions are described in Annex 3.

5. Essential preconditions and ingredients

5.1. Essential preconditions

A characteristic of many reforms is that they are introduced into an organisation with neither the willingness culturally to accept the reform nor the technical ability to understand and implement the reform, or indeed to maintain it once introduced. As a result, the reforms either do not succeed or they create distortions that have damaging effects and in either event are eventually abandoned or put to one side as other new ideas or fashions emerge.

Consultation and acceptance. This is a risk with the introduction of accrual accounting into a government organisation. To be successful, the organisation needs to be prepared culturally for its introduction and be willing to recognise and accept the benefits that the changes will bring about and the costs of implementation in their widest sense. The pre-consultation exercise within government departments and the public consultation exercise were therefore essential preconditions for success. Another prerequisite was a willingness by the civil service to accept that the reforms would change the role of accountants in government, significantly changing their influence and responsibilities.

Participation of the accountancy profession. A complementary precondition was that the accountancy profession was prepared to be interested and involved with the public sector. To be successfully implemented and operated, the reform required not only an increase in the number of accountants employed by government but an acceptance of their contribution to the efficient and effective management of the public services. There is much more to accounting than the reporting of information; it is rather a means to achieving management objectives. The government was willing to pay salaries sufficient to attract and maintain a cadre of qualified accountants. There was a sufficient flexibility within the training schemes of the accountancy profession to meet the education requirements of the public sector. The profession itself had an interest and willingness to become involved that was greater than that of either the auditor or consultant, both of whom could be seen to wish to become involved for their own long-term commercial interests.

All of these conditions did exist in the United Kingdom. Prior to the introduction of resource accounting and budgeting, there were relatively few accountants employed by the central government. Their role was generally a limited one. Most were employed by the Ministry of Defence to review contractual arrangements with defence suppliers. The accountant position in the central government was in no way similar to that of the finance director of a commercial company. (This was quite unlike local government where the accountant had had, since the 19th century reforms of local government, a key role as the "Treasurer" of the local authority with independent legal responsibilities even though operating within the operating structures of the local authority.) The introduction of resource accounting and budgeting has seen the establishment of accountants increase substantially and their position has changed from the periphery of management to a central and key responsibility. There is a "Head of the Government Accountancy Service" and originally this appointment was made to a peripheral department but is now a key post in the Treasury.

Joint development of accounting standards. The other essential element of co-operation was that the UK accountancy profession was willing to take an interest in the development of accounting standards for the public sector and to become involved in the application of those standards and the monitoring of their implementation. The profession needed to have the ability to comment from an independent point of view and this degree of independence also needed to be accepted by the government. This was done through FRAB. Without that willingness by both parties, the effect would have been that the government could be seen as setting its own accounting standards and applying them in a manner that suited the political circumstances of the moment. That would have damaged not only the credibility of the process but in the end would have meant that the disciplines that resource accounting and budgeting were meant to achieve would not have been established. Independence of the standards adopted with a critical appraisal process, whilst uncomfortable potentially for government, is essential. However that also means that the accountancy profession must have a capacity to both understand the nature of the public sector, to recognise that circumstances are different from those of the private sector and that comment, when made, has to be made and clearly made from a politically disinterested perspective.

Support of the government auditor. Successful implementation of accrual accounting does depend heavily upon the understanding of and willingness to support the system by the external auditor. In the United Kingdom, the National Audit Office has been particularly closely involved and has done excellent work in informing Parliament and working with the government. As accrual accounting requires not only more complex systems but also a range of new judgements (*e.g.* about asset values and lives, matching issues, prudence, materiality and going concern), the responsibilities and expectations of the auditor will change considerably. Therefore, the external auditor should be involved in the process from the outset. That may require that the organisation, career structure and training of auditor staff should be significantly changed. Auditors will need a thorough understanding of accounting principles and how those principles can be maintained under the pressure of day-to-day administrative decisions. That will require the appointment to the government audit staff of qualified accountants, rather than relying upon the more traditional training of auditors.

In the United Kingdom the National Audit Office had, for some years prior to the introduction of resource accounting, adopted professional accountancy training as its main training mechanism and it had also forged close relationships with the accountancy profession. The responsibility of the National Audit Office in the resource accounting system can be summarised as follows:

- to comment on the proposals for the application of United Kingdom GAAP by the Treasury;

- to advise Parliament (the Public Accounts Committee) on the implications of the adoption of resource accounting and budgeting for parliamentary control;

- to develop audit arrangements so that the auditor would be able to issue a "true and fair view" audit opinion;

- to carry out audits of the "shadow" resource accounts during the implementation process;

- to advise on the risks during the process of change and to monitor the program of change, reporting to the Public Accounts Committee as appropriate.

The auditor also needed to have the capacity (*i.e.* a sufficient degree of independence and technical robustness) to be able to refuse to provide a "true and fair view" opinion in appropriate circumstances and a refusal to grant such an opinion to some departments has been a feature of the process in the United Kingdom.

Comprehensive management training. There existed a need for training of departmental managers to use an accrual accounting system and to achieve the benefits from its operation. There are considerable differences between the information available to managers under a cash accounting system and the information available under an accrual accounting system. To make proper use of an accrual accounting system, managers need not only to understand the differences, but they also need to appreciate how they can use the accrual-based information to manage activity more efficiently and effectively. Therefore, an essential component of the introduction of an accrual-based system is a comprehensive management training program for line managers. Such a training program would need to cover the following:

a. An appreciation of the basic financial concepts underlying accrual accounting: Managers will need to understand how and why an accrual accounting system is different from a cash accounting system. They will therefore need to know about the basic financial concepts that underlie normal accounting.

b. How accrual accounting allows for the introduction of improved budgeting and financial control systems. Managers will need also to appreciate how control will change. The focus of control with a cash-based system is to ensure that cash expended in the period (or income collected) is neither greater nor less than forecast in the budget. The emphasis is therefore about "inputs" into the activity rather than what the activity achieved, *i.e.* outputs. With a cash-based system the main forms of management control will be on "time", *e.g.* when an invoice is to be paid, and it will frequently be possible for the manager to manipulate timing in order to ensure that budgets are met. With an accrual-based system this is considerably less possible and managers will not have any ability to influence time. They will therefore need to focus on resources used and the price paid for those resources. The management emphasis should therefore shift to efficiency and effectiveness and line managers will need training to not only appreciate this, but also to understand how they can make full use of accruals information.

c. An understanding of the accounting information systems that are needed: In addition to the general ledger system, other systems needed are: a purchase order system, an accounts payable system, and an asset register.

5.2. The essential ingredients

The United Kingdom has developed over many years a public sector cultural ethic that has internalised the requirements for a neutral (*i.e.* non-political) civil service. The civil service has responsibilities that are independent of ministers, and civil servants may be separately called before Parliament to account for their behaviour and activities. There is also a strong, well-regarded central agency, the Treasury, responsible for the management of the government finances. There are well understood systems of control over departments and latterly these systems of control have tended to focus more on the key areas, leaving it to departments to control the detail of the management of their activities. Only for these key areas is parliamentary approval required.

However, Parliament in its scrutiny of public expenditure may enquire into how a department manages its internal affairs as part of its regular system of reviews to secure value-for-money. There is also a comprehensive annual independent audit of the accounts of each department at the end of each financial year, with reports to Parliament and detailed scrutiny where appropriate. There is no *a priori* audit, thus leaving the whole responsibility for the control and management of expenditure with the spending department. There is little individual corruption and certainly no problem at all with endemic corruption of whatever sort. Therefore, no informal parallel processes have evolved to complement the formal processes and, consequently, rules specified about the introduction of resource accounting and budgeting will be obeyed.

There has also been from the outset a willingness to recognise that the introduction of resource accounting and budgeting will take time. In the United Kingdom political system, that has meant that the period taken for implementation would stretch beyond the lifetime of one Parliament (maximum five years and more generally four in practice) and could therefore stretch beyond the period of control by one political party. The system needed widespread political support across the political spectrum, and this it did have. When a Labour Government in 1997 replaced a Conservative Government, there was no fundamental change made to the proposals. Rather the opposite, they were reinforced.

Other essential ingredients were that the introduction of resource accounting and budgeting is seen as part of a process of reform and has not been "parachuted" in to a stable, unchanging management process. That management process has been undergoing reform over a long period of time. Another was that there was an established and interested accountancy profession with a well developed set of private sector accounting principles capable of application to public sector circumstances. This profession also had a prior involvement with the public sector and was prepared to work with it.

6. Lessons from the United Kingdom experience

6.1. Determinants of future success

The experiment with resource accounting and budgeting is by no means complete and will not be so for a number of years. Yes, the technical change is being achieved and achieved on time, but it is too early to say whether or not the change will be successful. That will depend upon a number of factors, including:

- how Parliament reacts to the information it will be provided with;
- how ministers use the information to improve the quality of policy- and decision-making;
- whether managers use the results to improve the efficiency and effectiveness of the delivery of public services, and that in turn also means:
- whether there is a genuine shift to an emphasis upon outputs rather than inputs and consequently the development of genuine and independent measures of output;
- whether there is increased symmetry in practice between economic and financial management.

If the reform fails to result in these improvements, it is unlikely that the whole system will be discarded unless there is a major failure in the control of public expenditure. What will occur is that elements of the system will remain, such as the development of asset registers and the recording of longer term liabilities like pensions. We may indeed see an increasing sophistication in the measurement of liabilities as, for example, concerns about environmental pollution increase and, even if the system stays, these concerns may assume greater relative significance over time.

6.2. Lessons

In terms of the actual implementation of the system, there are a number of lessons for countries that are considering using accrual accounting systems. These include:

Capability, judgement and scrutiny. Accrual accounting is far more complex than cash accounting and it requires the exercise of relatively sophisticated judgements. Therefore, the change should only be attempted if the cash accounting system is working effectively and has been doing so for some time. In addition, because of the need for a greater range of judgements, systems do need to be in place that will ensure that these judgements are subject to independent and equally sophisticated scrutiny. That scrutiny needs to have both a political and a technical content. The greatest risk with accrual accounting is that it will be used by those in control of the government machinery and by managers to show events in a better light than is justified. Business managers are just as prone to this as governments and, in the private sector, in order to prevent this, internationally accepted standards and a strong independent audit system have been developed. Despite this, serious failures and scandals occur. Governments are sovereign and therefore the temptation is to set in place accruals rules that allow the system to be manipulated. Success will depend very much upon how far the government of a country is willing to accept the need for rigorous independent scrutiny, criticism of the standards that are being applied and the results which flow from the application of those standards.

Culture of conformity with rules. More so than with cash accounting, both politicians and managers need to be willing to understand and accept the accounting rules. That should be the norm and divergence should be the exception. There needs to be a central agency that specifies the rules, and that the rules are regarded as fair and equitable, though they may not be liked. The rules must be obeyed, with appropriate punishment if they are not. Until this culture of conformity exists, because of the added complexities of accrual accounting, the cash system should remain.

Accounting and budgeting integration. Accrual accounting and budgeting should go together. Unless the budgeting system is on the same basis as the accounting system, the scope for mismanagement and a loss of financial control are considerably enhanced. There will be confusion about the meaning of information and the actual financial information about previous years' activities will always remain, for most operations, the basis of future budgets.

Outputs over inputs; performance over control. There has to be a willingness to accept significant changes to the methods of control and the distribution of responsibility. The nature of control and budget-making should also change in order to achieve the full benefits of accrual accounting and budgeting. The emphasis should be upon the control of outputs rather than inputs. Traditional controls may be relaxed in order to provide managers with the opportunity to manage effectively. A manager is not able to manage outputs unless he/she has relatively greater freedom over inputs, such as staffing and capital, than most public sector control systems presently allow. On the other hand, this also means more rigorous disciplines being exercised over managers who fail to deliver the performance expected. This degree of cultural change also requires investment in the training of managers and even the employment of those who have an entrepreneurial-type ability. In turn, the system of check, most notably of internal control and external audit, needs review and strengthening.

Perseverance. The introduction of accrual accounting and budgeting takes time. Unless there is a widespread intellectual acceptance of the desirability of introducing the reform, the risk is that, with a change of political control or of personalities, the reform will not be brought to fruition. The consequence would be most unsatisfactory and considerable investment would have been wasted.

No gains without sacrifice. The nature of the change and the need for widespread intellectual acceptance requires broad initial discussion of the proposals to convince the responsible officials. They are the ones to operate and ensure the effective use of the system. In order to realize the benefits from the change, they may have to make difficult decisions. These decisions may include closing or reorganising operations, removing staff, changing delivery arrangements, introducing user charging and competitive and regulatory arrangements.

Ascendancy of accounting. Considerable accountancy skills are required to introduce and maintain the system and proper processes of financial management. This will mean changes within the official administrative power structures and the growth in unaccustomed influence of accountancy. Where are these accountants to come from and will the public sector offer sufficiently good pay and conditions to attract and retain them? Substantial investment in training of existing administrative staff is also required to secure an understanding of the information being provided and the new management arrangements, This applies equally to the staff of the external auditor, otherwise the auditor will act as a “drag” on progress.

Institutionalisation of change. As the resource accounting process is a dynamic one driven by both developments in accounting practice and the circumstances of government, a capacity is needed to ensure that there is a systematic arrangement to incorporate change into the accounting and reporting processes.

Information technology capability. Without an information technology (IT) capability, it will be difficult to assemble the information required and provide the information necessary for or efficient management of operations. More complex IT systems will be required than those associated with a traditional cash system.

Overall, making the present cash system work better is a precursor to the introduction of accrual accounting and budgeting. RAB is not a solution to the problems of the present cash system, and should not be regarded as such. Nor should accrual accounting be supported just because it is the current international fashion. A concomitant to accrual accounting is the need for an appreciation by line management of the benefits that it will bring. Without that, any technical gains are unlikely to result in real benefits in terms of improved efficiency and effectiveness in the delivery of public services.

6.3. Summary

The introduction of accrual accounting and budgeting in the United Kingdom should be regarded as part of a long process of reform. That process will not cease now that the decision to move from cash-based systems has occurred. Rather the likelihood is that it will build upon the RAB system. Whilst this particular reform has been introduced relatively smoothly, important concerns have been expressed by Parliament. The future success of RAB will critically depend on how Parliament reacts to the information it is provided with and whether or not it regards the implementation of the reform as robust. Parliament will also want to see tangible benefits emerging through improved management and better public service performance.

The accountancy discipline is also under pressure. Can its members provide the skills that the civil service needs? What is more, can it provide them successfully in government, where non-market considerations are paramount? Can it also ensure that it is able to manage the process of developing accounting standards without creating a fundamental conflict with government?

All the signs are that in the United Kingdom the reform will be successful. There will be difficulties, but the structures and the will exist to overcome them. The culture both in the civil service and in the accountancy profession will promote success. Yet, any observer must recognise that, at this point in time, the experiment is by no means completed.

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ANNEX 1
APPLICATION OF UNDERLYING CONCEPTS

Subject Area	Application
Customer income	• Customer income in the form of sales, fees, charges and rents would be accrued and accounted for in the period to which it relates.
Employee costs	• The full cost of employees would be charged to the accounts of the period within which the employees work. Material amounts earned but unpaid at the end of a period would be accrued.
Supplies and Services	• The cost of supplies and services would be accrued and accounted for in the period during which they are consumed or received. Material sums unpaid at the end of a period for goods or services received or works completed would be accrued.
Recognition	• Direct expenditure on the acquisition, creation or enhancement of fixed assets would be capitalised on an accruals basis. Expenditure on the acquisition of a tangible asset or expenditure which adds to, and not merely maintains, the value of an existing asset, would be capitalised and classified as a fixed asset, provided that the fixed asset yields benefits to the body and the services it provides for a period of more than one year. Capitalised expenditure would include expenditure on: - acquisition, reclamation, enhancement (such as extending the life or increasing the value of the asset) or laying out of land; - acquisition, construction, preparation, enhancement (as above) or replacement of buildings and other structures; - acquisition, installation or replacement of movable or immovable plant, machinery, apparatus, vehicles or vessels. (Small items would not be capitalised.)

Subject Area	Application
	Under this definition, improvement works and structural repairs would be capitalised, whereas ordinary jobbing maintenance to buildings, including painting and decorating, would not be included. Assets acquired under finance leases would be capitalised and included together with a liability to pay future rentals. Where a fixed asset is acquired for other than a cash consideration of where payment is deferred, the asset would be recognised and included in the balance sheet at "fair value".
Measurement	• Fixed assets will be included in the accounts at their value to the activity by reference to current costs.
Revaluation	• Fixed asset values would be reviewed annually and adjusted if necessary. Professional valuations of land and property would be carried out at least once every five years.
Military, infrastructure & heritage assets	• The treatment of these has been described above in the comments on the Consultation Paper.
Depreciation	• Provision for depreciation would be made by allocating the value of assets, less any estimated residual amounts, as fairly as possible to the periods expected to benefit from their use. The useful lives of assets would be estimated on a realistic basis and only revised where justified in the light of further experience. Freehold land would not be depreciated. How leases would be treated would depend upon the type of lease. A finance lease would be capitalised and an operating lease treated as an expense.
Pension	• Pension costs are not funded and, for the main civil service pension scheme, departments make payments to a "Superannuation Vote" administered by the Treasury. Such contributions would be accounted for by departments as an expense.
Stocks	• Stocks would normally be included in the balance sheet at the lower of cost and net realisable value. Where, however, stocks represent a significant proportion of total assets and are materially affected by changing prices, they would be recorded at the lower of their current replacement cost and the recoverable amount.

Subject Area	Application
Foreign Exchange	• Income and expenditure arising from a transaction denominated in a foreign currency would normally be translated into £ Sterling at the exchange rate in operation on the date on which the transaction occurred. (Exchange differences arising from the above would be included as part of the operating costs for the year.)
Post Balance Sheet Events	• Where a material post balance sheet event occurs, changes would be made in the amounts to be included in the Statement of Accounts.
Provisions	• Proper provisions would be required for any liabilities or losses likely (or certain) to be incurred, where there is uncertainty as to the amounts or the dates on which they might arise. Provisions, or changes in provisions, would be charged to the operating cost account; related expenditure would be charged directly against the provision. Provision would be made against debts known to be uncollectable and those judged to be doubtful.
Value Added Tax (VAT)	• An expenditure tax charged at the rate of 17.5% on most goods and services: Expenditure, income and asset values would be stated exclusive of VAT, except for irrecoverable VAT on expenditure and asset purchases.
Tax Revenue	• Tax revenue has traditionally been accounted for on a cash basis, using statistical forecasts of anticipated receipts. This basis would be continued with resource accounting.

ANNEX 2
QUESTIONS AND ANSWERS ON RAB

The specific concerns of the Public Accounts Committee and the answers from the UK Treasury were set out in the 67th Report of the Public Accounts Committee, Annex F.[14] They are quoted below.

Question: Will the principles and procedures of Supply be maintained under resource accounting and budgeting?

Response: These have been characterised by the PAC as:

- no expenditure without legislation;
- supplementary estimates when overspends foreseen;
- an absolute limit to spending;
- annuality of voted sums;
- separate authority for overspends;
- emergency spending subject to Parliament's authority.

The government has accepted that these principles will continue to apply to a resource-based system of supply.

Question: Since an accruals basis of accounting requires more judgements and estimates than the certainty offered by the existing cash basis, will parliamentary control be diminished?

Response: There will be more judgements but mainly in respect of areas previously not featured in the accounts and only partially visible to Parliament – assets and liabilities being the obvious example. The set of statements proposed at estimate and accounts stages offers far greater information than now and, because of the output and performance dimension, even more than large private sector organisations. In constructing estimates, departments will have to provide more of the underlying assumptions and workings behind the headline figures. Generally, there will be more limits voted for a department, which will tend to increase the framework for parliamentary control. It is unclear whether there might be more requests for supplementary provision as there would be two types of limit which could be breached – cash and resource. At accounts stage, there will be far more material to explain a department's results and to form the basis of any subsequent investigations by the NAO or Select Committees.

Question: If, in cash terms, only net expenditure is being controlled rather than net expenditure and appropriations in aid, will there not be a reduction in control?

Response: If net expenditure and appropriations in aid were controlled on both cash and accruals bases, departments would effectively be running both an income and expenditure *and* a payments and receipts system. This would be over-specified, costly and inefficient for departments. The government proposes to place reliance on accruals measures of income and expenditure to do the brunt of the detailed work in terms of control. Thus, departments would have to recognise expenditure at an earlier point than in a cash system, for example when an invoice is received. If a department was pressing against its resource expenditure limit, recognising the receipt of an invoice might in itself trigger a breach of a parliamentary limit. The same considerations apply to recognition of income, which would also be controlled in accruals terms. Compared with now, Parliament would not have limits set on gross cash payments. But departments would not be able to accrue expenditure, in advance of paying out cash, without increasing their resource expenditure and moving close to, or even beyond, their parliamentary resource limit. The same considerations would apply to income. Thus, there would be control over gross expenditure in accruals terms, since there would be parliamentary limits on net expenditure and income. There would also be parliamentary control over the net cash (payments less receipts) required to support the voted level of gross accruals expenditure. Taken together, this is designed to provide Parliament with control over accruals measures of gross and net expenditure which are sufficient to deliver a set limit for net cash outlays.

In relation to capital expenditure, the reconciliation in the estimates between resources and cash required would specify the forecast cash expenditure on capital purchases. Departments would have flexibility to manage their working capital to meet both the cash and accruals targets. With a regime for efficient cash management, there will be very powerful incentives for departments to manage both cash and resources. This is a discipline that other well-managed parts of the economy take for granted.

Question: Under resource-based estimates would cash and/or resources be voted and how would dual voting be reconciled?

Response: The items which it is envisaged would be voted in a resource-based estimate are:

- the accrual-based figures for net resources and for appropriations in aid for each of the department's requests for resources;

- a single appropriations in aid figure for capital receipts; and

- the total cash requirement for the department, which would be calculated by reconciling the net resource total to the cash figure by means of removing non-cash items; adding capital expenditure and cash generated from the disposal of fixed assets; and by taking account of changes in working capital and long-term liabilities.

Question: At what level of detail will parliamentary voting and authority apply in the resource-based estimates?

Response: The working assumption is that Parliament would be asked to vote net resources and appropriations in aid for each request for resource whilst cash would be voted as a single figure for each department. In addition, Parliament would be asked to vote a single figure for each department for non-operating cost appropriations in aid.

Question: Will capital be presented and voted gross or net in the resource-based estimates?

Response: The intention is that capital purchases and disposals will be shown separately, with a separate limit on non-resource budget appropriations in aid. Details of significant long-term capital projects will continue to be shown in the departmental report.

Question: Will the resource-based estimates be supported by a forecast balance sheet?

Response: There are no plans to do so, because the relevant data is shown in the supporting statements to the estimates (and in the departmental report, *e.g.* details of long-term capital projects) therefore the forecast balance sheet would be repeating information already available.

Question: Are there "creative accounting wheezes" that departments might be able to use to their benefit?

Response: Concerns have been expressed about the dangers of "creative accounting" for the public sector. However, it is worth remembering that there are a number of constraints on central government which are not present in the private sector (five of which are listed below). The public sector will be subject to rules and scrutiny which provide additional safeguards against massaging the figures in their accounts.

First, the FRAB (see below) will advise on revisions to GAAP and on new accounting standards and these will then be incorporated into the Resource Accounting Manual. The Resource Accounting Manual is the detailed manual issued by the Treasury setting out how resource accounting and budgeting is to be implemented. It is updated annually and can be obtained from HMSO in CD format. Departments will be required to prepare their resource accounts in accordance with the Manual, which means that they will be required to live within the rules contained within it.

Second, the PES (Public Expenditure Survey) round and scrutiny of departments' estimates and resource accounts by the Treasury will result in checks being applied to ensure that accounting policies and the presentation of the accounts are not altered from year-to-year without a justifiable reason.

Third, the NAO in auditing the department's accounts will need to approve the accounting policies used in the preparation of those accounts. The onus will be on the department to make the case for any changes to the NAO on the grounds that, if the changes were *not* made, then the accounts would not present a "true and fair" picture. In addition, the Comptroller and Auditor General as a single auditor for government provides consistency across departments.

Fourth, *Government Accounting*[15] contains rules on propriety that a department will need to abide by when preparing its accounts.

Fifth, the public sector is different from the private sector and many of the major problem areas in the commercial world are largely absent in government. In particular, there is an absence of mergers and acquisitions in the public sector, foreign currency transactions are limited and the results of trading do not impact on share prices.

ANNEX 3
PUBLIC ACCOUNTS COMMITTEE'S SPECIFIC CONCLUSIONS ON RAB

The risks remaining

(i) Some departments have yet to appreciate fully what is entailed in preparing resource accounts, and inexperience may have led to an under-estimation of the difficulties. It is critical for those departments that received a qualified audit opinion on their 1998-99 dry run accounts that they give sufficient priority to rectifying the deficiencies before 2001-02.

(ii) The lateness in rendering 1998-99 dry run accounts for audit may in part result from the pressure to prepare simultaneously appropriation accounts and resource counts. However, the trend towards late accounts pre-dates this dual running and the departments concerned and their accounting officers will need to find and rectify the causes.

(iii) Staffing is clearly a problem in some departments. The preparation of resource accounts calls for a far higher degree of technical skill than the present cash-based appropriation accounts. Unless adequate numbers of suitably qualified and knowledgeable staff are in post the necessary improvements will not be achieved.

(iv) Staff training will also be needed for a wider range of staff, so that the whole level of financial expertise in departments is raised. Accounting Officers have given the Treasury assurances that steps are in place to promote the relevant training, and it is vitally important that departments see through their programs for training staff.

(v) In spite of a very long period of preparation, some departments have still not introduced systems that are capable of fully supporting their resource accounts. In most cases these deficiencies affect only parts of the accounts, and they vary in their seriousness. Departments nevertheless need to take all deficiencies seriously and rectify them as soon as possible.

Management information systems

(vi) Unless resource estimates and accounts form the bedrock of financial management in departments much of their value will be lost. Sound management accounts should be part and parcel of departmental systems. We look forward to receiving the Treasury's detailed analysis of the use departments are making of their management information systems.

Additional safeguards

(vii) The Treasury have proposed the extra safeguards for the transition from cash to resource-based supply. Nonetheless for departments that received a qualified audit opinion on their 1998-99 dry run accounts the Treasury need to continue to monitor progress closely, and to see that departments address fully the areas of risk identified during the dry run. The committee's agreement to proceed rests on the Treasury's acceptance of this role.

(viii) The Treasury has told us that they are quite clear what the problems are; that they can see the timescale in each case for resolving them; and that they are going to monitor against precise targets. We therefore expect the Treasury to:

- ensure that departments have action plans that fully identify, as appropriate, the staffing, training, and systems problems that face the department, and the actions necessary to resolve these problems before 2001-02;

- provide the committee with a summary and analysis of each of these action plans by Autumn 2000; and

- monitor departments' progress and provide further reports to the committee on the quality of their resource accounts for 1999-2000 as soon as possible after 31 January 2001 – which is the statutory deadline for laying those accounts.

The reports to the committee will need to include an analysis of the audit opinions given on those accounts. They should provide, as appropriate, information on the progress each of the departments has made since those accounts were prepared, and the prospects for the 2000-01 and 2001-02 accounts.

(ix) On the basis of these reports and the advice of the Comptroller and Auditor General, we may wish to seek further written or if necessary oral evidence from the accounting officers of any departments where the pace of progress may be insufficient.

(x) The issue of accounts directions[16] for the preparation of resource accounts is a matter for the Treasury. However we see little advantage, and some potential difficulty, in the issue of such directions to departments which have not fully demonstrated the capacity to produce resource accounts of an auditable standard.

(xi) Resource-based supply has developed to the point where detailed parliamentary controls have been clarified. We are content that these controls sustain the principles underlying the present cash-based system and accept the government's proposals as the basis for introducing the new system.

(xii) We nonetheless recognise that all the effects of the change to supply will only become fully apparent once the new system is in operation. We may therefore wish to re-examine any particular features that the Comptroller and the Auditor General may subsequently bring to our attention.

The role of departmental select committees[17]

(xiii) We encourage departmental select committees to review the new forms of estimates and the accounting information that the new system provides for their respective departments.

NOTES

1. In practice different definitions of the public sector are used for different purposes and there are some public sector bodies that exist in some parts of the United Kingdom, but not in others – water authorities in Scotland, for example.

2. The accounting officer is the senior official responsible for the propriety and regularity of a department's expenditure, and for prudent and economical administration.

3. Cm 2626 London: HMSO.

4. An initiative commissioned by the United Kingdom Government in 1982 to promote in central government clear objective-setting with measurable performance outputs, well-defined responsibility for the use of resources and a stress on value for money.

5. Government Resources and Accounts Act 2000.

6. Report for the period May 1999 to March 2000.

7. Cm 2929 London: HMSO.

8. Likierman, A. (2001), "From Planning and Implementation: the New United Kingdom Central Government Financial Framework". *Public Money & Management*, Vol. 21, Number 1, pp. 53-56.

9. A supply estimate is a statement of expenditure ("supply") for which the government asks Parliament to vote authority in the forthcoming year.

10. PAC 97-98/186 and 225.

11. Appropriations in aid is a term used to describe all types of receipt which, with Treasury authority, are included in supply estimates to offset expenditure on a vote.

12. PAC 29th Report 1999/2000.

13. Appropriation accounts – the outturn of voted expenditure in the past year is reported to Parliament in the form of “Appropriation Accounts”; the outturn is audited by the National Audit Office.

14. Published 27 July 1998 House of Commons.

15. “Government Accounting” provides guidance on the proper handling and reporting of public money The advice it contains falls into three categories: Parliamentary requirements which have been set out in legislation, reflect parliamentary procedure or have been agreed between the Treasury and Parliament. Treasury administrative controls and Best Practice.

16. Formal documents issued by HM Treasury or a sponsor department to a public sector entity detailing the content of accounts and the way in which they are to be presented.

17. Parliamentary Committees established to monitor government department activities and policies.

GOVERNMENT ACCOUNTING AND BUDGETING REFORM IN NEW ZEALAND

BY
JUNE PALLOT*

1. Introduction

New Zealand's state sector reforms have attracted considerable international attention over the past decade for their speed, comprehensiveness and explicit theoretical framework. Accounting and budgeting have formed an integral part of these reforms with New Zealand being possibly the first country to place appropriations, budgeting, output costing and external reporting, including whole-of-government financial statements, on a full accruals basis. While it is true that most of this change to outputs-based accrual accounting took place in two short years following the passage of the Public Finance Act 1989, it would be a mistake to characterise the transformation as solely a one-time overnight revolution or "great leap". It is important to see continuity as well as change for the system today is the accumulation and synthesis of what has gone before. In short, the evolution of the New Zealand system is a "long march" which is still in progress.

This paper examines the various stages in evolution of the financial management system in New Zealand central government over the past two decades. It focuses on more recent changes but seeks to ground them in what went before, the forces at work, the mistakes made and the lessons learned. The timing of the stages is marked by key documents or legislation which captured the changing ideas and attitudes within the public sector. Following the description of the stages of the reform, the paper examines in more detail the factors which facilitated change in New Zealand, and concludes with an overall assessment of progress to date.

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2. Stages of reform

While there is naturally some overlap between them, the phases of central government reform in New Zealand, in the author's mind, can be identified as follows:[1]

- A *Traditional Phase (prior to 1978)* characterised by administrative hierarchies, procedures to ensure uniformity of treatment, cash accounting and controls over inputs.
- A *Managerialist Phase (1978-1985)* characterised by attempts to introduce private sector management techniques, including accrual accounting, into public sector organisations.
- A *Marketisation Phase (1986-1991)* characterised by the combination of managerialist ideas with economic theories emphasising individualistic self-interest, competitive markets and contracts. This is the period of the "great leap".
- A *Strategic Phase (1992-1996)* characterised by an emphasis on whole-of-government strategizing in an effort to focus on the longer term and to overcome the fragmentation created during the marketisation phase.
- An *Adaptive Capacity Phase (1997-)* characterised by a focus on maintaining and developing *capability*, especially in human resources and skills. A new electoral system places a premium on political awareness of managers and on continuity in the public service.

2.1. Traditional and Managerialist Phases (to 1985)

The traditional system of financial management in New Zealand Government, as in many other countries, was one of cash accounting and centralised controls over the cash cost of inputs under standard expenditure groups such as personnel, travel, materials, capital expenditure or transfers. The personnel system of the public service was likewise highly centralised with personnel policies governed largely by rules and procedures first introduced in the *Public Service Act 1912*. These rules ensured a merit-based non-political career service, but made it extremely difficult for departments to recruit employees for positions above the basic grades from outside the service. Critics charged that the promotion and payment systems rewarded length of service over performance, and gave managers almost no discretion to apply rewards and sanctions according to performance.

Following a review by the Treasury in 1967 attempts were made to introduce aspects of the Planning-Programming-Budgeting Systems (PPBS) which had gained popularity in government budgeting in the United States. However, according to a report by the Controller and Auditor-General (C&AG, 1978), cash accounting and the failure to develop meaningful performance measures meant that managers continued to focus on budget and legal compliance rather than managing resources effectively and efficiently.

In the wake of the C&AG's report, New Zealand experimented with a variety of practices (collectively referred to as "managerialism" by observers of similar trends in Britain, Canada and Australia). Under slogans such as "Let the Managers Manage" and "Managing for Results", private sector practices, such as corporate planning, increased budget flexibility, and new management information systems, together with progressive dismantling of Treasury regulations and *ad hoc* attempts at non-financial performance measurement, were tried with varying success (Pallot, 1991). "Value-for-Money" audits were introduced by the Audit Office and the New Zealand Society of Accountants made an early commitment to accrual accounting and non-financial performance measures for public sector entities.

2.2. Marketisation Phase (1986-1991)

The years after 1986 are marked by the application of a series of common principles to reforms across the entire public sector including central government departments, local government, the health and education sectors and a host of miscellaneous state agencies (Boston, 1989). When the fourth Labour Government came into power in 1984, the Treasury already had ideas as to how New Zealand's overall budgetary situation might be improved. These ideas came in the main from a core of policy analysts within the Treasury, influenced by international intellectual currents favouring market liberalism. Initially suppressed by Prime Minister and Minister of Finance, Robert Muldoon, these ideas became free to surface in the policy arena under the new generation of politicians elected in 1984. According to Scott, Bushnell and Sallee (1990), key Treasury officials during the process of reform, the most influential bodies of theory on which they drew were "public choice", "agency theory" and "transaction cost analysis".[2] Public choice was applied in efforts to reduce the role of the state, decouple policy advice and regulation from policy implementation, enhance transparency of state subsidies and political interventions (*e.g.* in state commercial enterprises), and to make all services provided by the state (including ministerial policy advice) as contestable as possible in an attempt to counter potential self-interested behaviour of politicians and government officials. The influence of the agency theory can be seen in an enhanced emphasis on performance specification, reporting and monitoring, together with the application of incentives and sanctions. The influence of transaction cost analysis can be seen in the structural reforms wherein government is viewed as a complex series of contractual relationships.

The Labour Government spent its first few years deregulating the private sector so as to improve the overall economic performance of the country. In 1986, it turned its attention to the public sector in the expectation that improving its performance would contribute to overall improvement of the economy. The *State Owned Enterprises Act 1986* (SOE Act) marks the beginnings of the contemporary New Zealand model of public management. The various types of public enterprise were brought under this one common statute, the principal objective of each enterprise being "to operate as a successful business". Key components of the new model included a clear identification and separation of the roles of ministers and boards/managers and the reporting of actual performance against prior specification of objectives (Statements of Corporate Intent). If the government wished an SOE to undertake unprofitable activities for social reasons, it was to make specific payments to the SOE for these. The SOE model has since been adopted for state entities serving a mix of commercial and social objectives (for example, Crown[3] Research Institutes). Here the purchase interest of the government is much stronger, with the major part of revenue coming from the government rather than directly from the public at large.

After the establishment of SOEs, attention turned to core central government departments. Two key pieces of mutually reinforcing legislation – the *State Sector Act 1988* and the *Public Finance Act 1989* – formed the basis of the reforms in central government departments. The *State Sector Act* – which was designed to promote more efficient, responsible and accountable management of public agencies – brought significant changes to the process of appointing departmental chief executives and ushered in a new era of devolved human resource management (Walsh, 1991). To strengthen the rewards and sanctions available to ministers, chief executives ceased to have permanent employment but were placed instead on renewable performance-based contracts of terms not exceeding five years. Chief executives gained unprecedented flexibility in their powers to hire and fire staff and to determine their remuneration. The passing of the Employment Contracts Act (which applies to both the public and private sectors) in 1991 introduced individual contracts of employment between employer and employee, moving away from the active state involvement and sponsorship of collective negotiation that had persisted since the late 19th century.

To complete the reforms initiated by the *State Sector Act*, a clearer definition of the notion of performance, together with a comprehensive overhaul of the financial management system, was required. The reform that had already been initiated with the SOE model was felt to be a useful starting point, along with the set of principles that guided that process. Private sector practices were also examined to see whether there were any concepts that could be usefully applied in the public sector. Two sets of ideas underpinned the new system of performance measurement (Pallot, 1991; McCulloch and Ball, 1992).

The first set of ideas was a distinction between *inputs* (resources such as labour, materials, electricity) *outputs* (goods and services such as policy advice, administration of regulations, administration of transfer payments, education, prison management) and *outcomes* (impacts on the community such as lowered incidence of disease or a lowered crime rate). The second set of ideas was the notion of two types of *contractual* relationship between departments and the government. In the first type of contract, the government was seen as a *purchaser* of outputs from departments or, alternatively, from organisations in the private sector. In the second type of contract, the government was viewed as *owner* of its agencies interested in getting the best possible return on the assets invested. The need to compare costs of services with those provided by the private sector and the need to establish return on assets were the reasons behind the introduction of accrual accounting. Based on these notions of ownership and purchase interests and departmental accountability for outputs, the *Public Finance Act* (PFA) redefined the appropriation process, shifting the emphasis from inputs to outputs, and established departmental and whole of government ("Crown") reporting requirements (Pallot, 1991; McCulloch and Ball, 1992). The shift to a full accrual-based appropriations and accounting system made possible the introduction of a capital charging regime to encourage better asset utilisation (McCulloch, 1992). By 1991, a mere two years after the passage of the PFA, all departments were accounting, costing and budgeting on a full accruals basis.

2.3. The Collective Strategy Phase (1992-1996)

Following the 1990 general election, a National Government replaced the Labour Government but this had no effect on the direction of the reforms and the same neo-libertarian economic policies were pursued. In 1991, the government appointed a steering group, chaired by IBM chief executive Basil Logan, to review the state sector reforms. While finding senior managers and ministers very supportive of the changes and the improvements in performance that had resulted, the steering group saw the need for further senior management development and further improvement in the specification and review of performance. The most widespread concern, however, appeared to be government-wide strategy co-ordination. Some ministers considered that the reforms had adversely affected elements of the collective interest (such as the co-ordination of policy advice, support for collective decision-making and efficient resource management) and advocated greater collegiality among chief executives as a means of redressing this. There was a perception within the public service that the reforms, particularly with their hierarchical accountability relationships, had encouraged "verticality" rather than "horizontality". Contracting out to a host of single purpose entities in a competitive market seemed to further encourage fragmentation rather than interdependence. Chief executives emphasised the constitutional responsibilities of Cabinet and ministers to provide leadership and strategy; in particular, an integrated view of ultimate policy goals which would help individual ministers to specify outcomes. While the steering group recognised that the budget process was a comprehensive look at the government's priorities and a central expression of Cabinet's collective responsibility, it felt that the budget was produced in conditions of secrecy and haste which placed genuinely strategic thinking under pressure and was not conducive to good decision-making (Logan 1991).

One of the first visible signs of a renewed emphasis on the government as a whole was whole-of-government accounting and budgeting. In 1992, New Zealand became the first sovereign government in recent history to produce whole-of-government ("Crown") financial statements on a full accruals basis (Pallot, 1994). The information contained in the Crown financial statements exceeds that produced by companies in the private sector and includes an operating statement and separate statements on financial position, cash flows, borrowings, commitments, contingent liabilities, unappropriated expenditure or costs incurred, emergency expenditure or costs incurred, accounting policies, trust money held by the state and such other statements as are necessary to fairly reflect the financial operations and financial position of the state. For most of these statements comparative figures for the previous year must also be provided. The financial statements are accompanied by extensive commentary and charts which indicate trends over time. Financial statements at all levels in the New Zealand Government are described as being on a "modified historic cost basis" although effectively they are close to being on a current cost basis. For example, all fixed assets (including infrastructure and heritage assets) are revalued at least every three years. The New Zealand Government has therefore moved further towards current value accounting than most organisations in the private sector in New Zealand.

The statement of financial position reports all physical assets including state highways, national archives, national parks and specialist military equipment. For various reasons, including the difficulty of valuation, the power to tax is not included as an asset. Liabilities to specific external parties are reported in the statement of financial position where they are probable and can be reliably measured. Consequently, pension liabilities to current and past government employees are included but the present value of future pensions and other welfare benefits to citizens at large are excluded. Other statements report commitments (quantifiable and non-quantifiable) and contingent liabilities. Revenues and expenses are also on a full accrual basis and include depreciation of infrastructure assets. Where possible, revenue from taxation is recognised at the time the debt to the state arises and is reported in the period to which it relates. Pallot (1994) provides a more detailed description of the "whole-of-government" financial statements and analyses the accounting and valuation issues involved.

The initial benefits from the Crown financial statements were that they improved accountability to Parliament, extended the range of information for assessing the government's fiscal position and made managers conscious of the need to properly manage assets under their control (Audit Office, 1993). When the "whole-of-government" financial statements began to be produced monthly after 1994, their usefulness increased. Not only could they be compared against the new forecast information (see below) but they ensure that continuous attention is paid to the fiscal position. Under full accrual accounting it is no longer possible to hide the costs of decisions (such as superannuation, defence contracts) that have medium- to long-term financial implications as they show up in the financial statements within eight weeks at most. This differs from a cash accounting system where only the current year's costs would show and the remainder would not be visible on financial statements until subsequent years, perhaps after an election. Conversely, on the asset side, full accrual accounting is likely to remove the bias against capital investment which might have existed under cash accounting because it would have appeared as an expenditure of the immediate period.

Changes to the budget process were the next whole-of-government initiative. In part these initiatives reflected a concern that loosely bound governments under the impending new electoral system (Mixed-Member Proportional or MMP)[4] might be less able to resist temptation to adopt short-term fiscal strategies which were inconsistent with longer term goals (Richardson, 1994). The reforms to the budget process were introduced through the *Fiscal Responsibility Act 1994* (FRA). This act requires governments to state their fiscal objectives and report progress towards achieving those objectives in the belief that this will "encourage the government to take a longer term perspective to fiscal management" (Treasury, 1994). Furthermore, the FRA is expected to allow better and more focused debate about fiscal policy as a result of the improved information available. This information includes a budget policy statement, a fiscal strategy report and a series of regularly updated economic and fiscal forecasts, including one prior to a general election. Both forecast information and subsequent reporting must be in accordance with Generally Accepted Accounting Practice (GAAP) established by an independent body under the Financial Reporting Act 1993. In most countries the government is reluctant to give away the power to choose its own accounting rules. The New Zealand Government, by contrast, saw value in committing itself and future governments to a regime in which their fiscal plans were as transparent as possible. Transparency would be diminished, however, if governments could manipulate accounting policies.

Rather than setting mandatory fiscal targets which experience suggests might merely result in misrepresentation to create a favourable impression, the FRA (Section 4:2) sets out principles of responsible fiscal management: ensuring operating surpluses until state debt falls to “prudent levels”; maintaining zero operating balances on average over time, once prudent levels have been reached; achieving and maintaining sufficient net worth to act as a buffer against adverse impacts in the future; prudent management of fiscal risks; and, predictability in the level and stability of future tax rates.

The introduction of a formal strategic phase, culminating in the production of a budget policy statement openly discussed prior to the drawing up of the budget itself was an important new initiative in whole-of-government priority setting. From 1995, this strategic phase required ministers, individually and collectively, to be explicit about their priorities and to translate the government’s broad vision statements into specific strategies to be pursued by the public service in major areas of social policy (*e.g.* economic growth, enterprise and innovation, education, community security, social assistance, protecting the environment). These Strategic Result Areas (SRAs) were established for the following three to five years in discussions between ministers and officials and agreed to by the Cabinet as a whole at a full-day strategic planning retreat held about three months into the current financial year. As well as forming the basis for the budget policy statement, the SRAs were linked to Key Result Areas specified in the performance agreements between chief executives of departments and ministers. The hope was that the budget would be developed *within* a more clearly articulated set of priorities rather than being the *de facto* driver of strategy (Fancy and Matheson, 1995). The National Government of 1996-1999 subsequently proposed “SRA networks” aimed at enabling trade-offs to be made across outputs which contribute to the same outcome and providing an opportunity for the middle ground between SRAs and KRAs to be mapped out. The present Labour Government has changed the terminology to “key goals” and “key priorities”.

2.4. The Adaptive Capacity Phase (1997-)

It would be surprising if the change of electoral system following the 1996 general election did not usher in a new era of public management; for example, as less stability in Cabinet membership places a premium on adaptive capacity of managers. Furthermore, stocktaking after 10 years of public sector reform generated a number of key documents. For example, in 1995 an Interdepartmental Working Party was convened to examine the ownership interest of government and redress the concentration on the shorter term purchase interest. The working party identified four key dimensions of the state's ownership interest in departments (Interdepartmental Working Group on Ownership, 1995):

1. *Strategic alignment* – strategic thinking and management within and across departments is informed by a common understanding of the government's priorities.

2. *Integrity of the public service* – departments reflect both the particular style of the government and enduring aspects of public value associated with good government.

3. *Assurance of future capability* – departments can meet expected future demand for outputs and are proficient in risk management and change management.

4. *Cost effectiveness over the long-run* – short-term price reductions do not translate into higher long-run costs and departments are not inappropriately locked into long-term commitments.

A major evaluation of the reforms in New Zealand was the 1996 report by American professor, Allen Schick (1996). The report identified a need to strengthen strategic capacity and recommended that accountability should encompass responsibility based not only on more precise specification of results, but also taking into account values, judgement and leadership. In the wake of such reports, the SSC has issued a number of key documents looking at development of the SRA/KRA model (State Services Commission, 1997a) and strategic human resource capability (SSC, 1997b). To address the integrity component of the ownership interest of government, the SSC in June 1997 issued standards of behaviour in a letter for chief executives. These various documents reflect an emerging new culture with roots in modern organisation theory, rather than economics. It is based on the realisation that there are limits to the gains to be had from specification and monitoring and that effective public governance now requires the capacity to design and execute long-term solutions to complex problems, often with fuzzy boundaries and both international and inter-generational consequences (SSC, 1997b).

This sort of thinking is also expressed in the 1999 report of the Controller and Auditor-General titled *The Accountability of Executive Government to Parliament.* The purpose of this report is, firstly, to promote Parliament's awareness of issues relating to the way in which it scrutinises and controls the Executive and holds it to account and, secondly, to point to opportunities for improvement and to stimulate debate about them (Audit Office, 1999). The report concludes that Parliament generally receives adequate financial information about what the government is buying (outputs) and the financial performance of state agencies. However, it questions whether all transactions for the provision of non-departmental output classes should be viewed as purchases. For example, a number of state entities are required by statute to undertake certain tasks and, in doing so, to act independently (*e.g.* the Police Complaints Authority, Privacy Commissioner). The sums appropriated are simply intended to fund those entities and it is quite wrong to categorise the economics relationship as that of purchaser and provider. *The Accountability of Executive Government to Parliament* also concludes that Parliament needs better information on: the reasons why the state should own a particular organisation; the nature and purpose of government spending; the impact and outcomes of government spending; the capability and performance of state-owned organisations; the Executive's use of imprest supply (temporary spending authority prior to receiving regular appropriation) ; and the assessment and management of risk. Throughout, the office proposes possible solutions, placing emphasis on *better* information rather than *more* information (while recognising the potential of improved information technology).

The "possible solutions" include an alternative to the financial management framework of the last decade with its private sector conceptions of "purchase" and "ownership". The purchase-ownership framework is criticised because the expenditure categories in the *PFA* (*e.g.* transfers) do not fit well with this classification and because the scope of government's interest is much wider than that of a private sector owner. It also identifies the relative lack of information on ownership compared to the information on purchasing/outputs. The Audit Office suggests that government expenditure be classified (the change of language is perhaps significant) as *current* and *capability* expenditure rather than as expenditure that reflects purchase and ownership interests. Current expenditure is defined as that which the government must incur to discharge its day-to-day business. It includes expenditure on outputs, transfer payments, debt servicing and expenditure to maintain capability. Capability expenditure is defined as that which the government must incur to establish or extend an agency's ability to produce outputs.

The Audit Office believes that this categorisation has a number of advantages. First, it provides a comprehensive classification since all expenditure can be placed in one of these categories. Second, it would foster realistic judgements about the relationship between expenditure and outputs. For example, it would avoid false impressions of efficiency gains by concealing or absorbing costs in output prices or by consuming capital or otherwise depleting capability. Third, it avoids any implication that that ownership interest can be fully reflected in balance sheet assets. Much of the information needed about key dimensions of ownership is not simply information about expenditure. Accordingly, the Audit Office proposes wider information requirements with respect to ownership including: the fundamental reasons why the state should own a particular organisation (as opposed to purchasing from, or regulating, an organisation it does not own); the particular contribution that owning the organisation is expected to make to the public good; the appropriateness of the organisation's corporate form (*e.g.* department, company, statutory corporation); and the organisation's capability.

Considerable attention is paid in *The Accountability of Executive Government to Parliament* to the notion of capability. The Audit Office suggests that Parliament may wish to consider "defining more precisely the role of a responsible minister in relation to capability – in terms that go beyond the narrow scope of financial management" (Audit Office, 1999). Also suggested is information on existing capability, the funding of changes to capability and information that relates changes in workload to changes in capability. Information on capability is important for accountability because it is difficult to establish accountability if it is unclear whether the organisation had the resources to do the job required of it. The Audit Office has given careful consideration to ways in which organisational capability might be comprehensively described, and how assurance about capability might be provided. It is currently undertaking work on how capability should be measured and reported. Although this work is not yet complete, the Audit Office believes that it is now possible to give Parliament some useful information on at least four dimensions of capability – balance sheet assets, human resources, outputs production methods, and information and control systems.

As well as challenging the purchaser-owner categorisation, *The Accountability of Executive Government to Parliament* identifies a number of issues with respect to outputs and outcomes – the other leg of the performance measurement framework. In the case of outputs, it is largely a matter of finishing up. The Audit Office notes that the contents of purchase agreements are not regulated by the PFA and can be changed at the discretion of the minister. On the other hand, descriptions of outputs in the estimates and departmental forecast reports (which are legally binding) are too vague, resulting in a reduction in Parliament's ability to exercise effective control over expenditure. The Audit Office proposes that outputs be specified in sufficient detail in the legally binding descriptions of appropriations for Parliament to have sufficient control. Descriptions in purchase agreements can be more specific, but they should be well-aligned with descriptions in the estimates and departmental forecast reports.

The criticisms of reporting on outcomes are much more severe. The Audit Office concludes that the government's statements about the overall effects (outcomes) of its spending are generally high-level and vague, that the Public Finance Act does not say how outcomes are to be specified or measured, and that there is no requirement to indicate their strategic priority. Linkages between outputs and outcomes are generally not clearly explained, several outputs from several agencies may contribute to the same outcome, and any particular outputs may contribute to the same outcome. Other forms of expenditure (*e.g.* transfer payments), and other forms of government involvement (*e.g.* regulation) may also contribute to outcomes. While successive governments have tried to address some of these difficulties through "strategic result areas" and "strategic priorities and overarching goals", these ancillary statements were first developed as tools to be used within the Executive, are not regulated, and are generally not measurable.

The Audit Office proposes a number of possible solutions, not least of which is a statutory requirement that outcomes actually be measured, and the impact of the outputs purchased by the state be evaluated. *The Accountability of Executive Government to Parliament* contains a section on impact evaluation (and its limitations) based on overseas experience. The Audit Office has since published a report titled *Impact Evaluation: Its Purpose and Use.* The intention of the report is "to demonstrate the value of impact evaluation as a practical tool to enhance the quality of decision-making by the government and Parliament" (Audit Office, 2000).

Several underlying themes can be detected in *The Accountability of Executive Government to Parliament*. Behind the emphasis on capability is a concern that the cost-cutting and apparent efficiency gains of the previous decade may have been at the expense of long-run efficiency and effectiveness. There also seems to be a recognition that in a rapidly changing and uncertain environment rigid planning-and-control models may not work, that risk is inevitable and that capability is crucial to organisational success. Given that "it is fruitless to hold individual to account for events or outcomes over which they have little or no control", the Audit Office (1999, p. 93) argues that the key consideration for accountability in relation to risk management is not that some unfortunate event has occurred. Rather, it is whether or not someone who had the *capacity* to mitigate that risk in a prudent and cost-beneficial way was negligent in not doing so.

Throughout, there are references to an accountability *dialogue* between Parliament and the Executive, suggesting that accounting (in its broadest sense) is not just a matter of measurement but also of communication; that measures are not exact but a basis for discussion and negotiation. *The Accountability of Executive Government to Parliament* also recognises that the changing environment poses problems for traditional hierarchical models of accountability. For example, government organisations often establish both formal and informal working groups ("virtual departments") to deal with specific issues or to pursue collective objectives. It may be that "no one agency is primarily accountable and that not external reports acknowledge the existence of the objectives, the resources applied collectively to pursuing them or the group's performance in doing so" (Audit Office, 1999b, p.20).

3. Factors affecting the success of implementation[5]

Before outlining the techniques which helped ensure implementation of key innovations in New Zealand, it is useful to discuss briefly the factors which make change more or less likely in any particular country. Hood (1995) refers to these as *motive* and *opportunity* while Lüder (1992, 1994) uses the terms *stimuli* and *contextual variables*. If both exist, there is strong political and administrative leadership, and an absence of barriers to implementation, then the likelihood of a country embarking on reform of its state sector is increased.

3.1. Stimuli and contextual variables

Common stimuli or motives for state sector reform include *fiscal stress* (an unsustainable level of public debt) and *political* or *financial scandal* (corruption or negligent or deliberate waste resulting in serious consequences for the taxpayers) (Lüder (1992, 1994). In New Zealand, the former was clearly the main stimulus. In the face of what was perceived to be an unsustainable level of public debt and successive downgrading of New Zealand's credit ratings, it was clear that improving the performance of that sector was crucial to improving the performance of the economy as a whole. Dominant theories and doctrines (new institutionalist economics and managerialism in the case of New Zealand) can further the effect of other stimuli or even function as stimuli on their own. These may be diffused across countries by international policy communities (Haas, 1992). If there is a new government, which can credibly leave political responsibility for mistakes of the past with the predecessor, there is added stimulus for change. The Labour Government elected by New Zealand in 1984 undertook an exercise of (to use its own terminology) "opening the books" to demonstrate to the public the sorry state of the economy and the need for fiscal restraint.

Opportunity for change depends on such factors as size, political and administrative structure, and the existing culture in government and in the society as a whole. New Zealand has a total population of 3.8 million and is geographically isolated, sharing no contiguous borders with any other country. Small size enhances speed of communication and makes it easier to obtain agreement. For example, New Zealand has a single body of professional accountants which encompasses the corporate sector and the public sector as well as accountants in public practice. Such an arrangement is conducive to the cross-fertilisation of ideas across the various sectors. Likewise, the New Zealand Treasury has responsibility for both economic and accounting matters whereas these functions are often divided between two separate departments in other countries. Their work converges in the preparation of the government's annual budget and whole-of-government financial statements. Geographical isolation places New Zealand in a better position to proceed independently than might be the case with other countries which constantly face cross-border implications of their activities.

Certain features of New Zealand's political structure may have contributed to the speed with which change was possible; in particular, it has a unitary government and unicameral legislature. As a unitary government, New Zealand does not have the problem of having to obtain agreement of a number of sub-national states amongst whom there are likely to be significantly different views. A unicameral legislature means that legislation can be passed much more quickly to effect change when required.

Finally, New Zealand noticeably lacked barriers to implementation such as an inflexible legal system, large size or complexity causing technical and administrative problems to multiply, inadequate staff qualifications or resistance from politicians or bureaucrats. Instead it had positive leadership from the Treasury (and more latterly the SSC) and successive Ministers of Finance. An administrative culture which had already shifted from bureaucratic to managerial thinking in the early 1980s, and a pioneering societal culture characterised by a pragmatic "do-it-yourself" attitude borne out of geographical isolation (Milne, 1966), provided fertile soil for the new initiatives.

3.2. Process variables

Once innovation enters the implementation phase, there are some techniques which can be used to help ensure the innovations are successfully implemented. Unlike the other variables, these are matters which are able to be controlled by the change agents. In New Zealand, the main such *process variables* have been: use of legislation, ordering of changes, coherence and consistency, and speed of implementation.

Use of legislation. While other countries may find that their Constitution and legislation have been a constraint on the development of national government accounting or more flexible employment practices, new legislation has been an impetus for change in New Zealand. These pieces of legislation often included tight time requirements for implementation. Statutes such as the *State Owned Enterprises Act*, *State Sector Act*, *Public Finance Act 1989* and amendments, *Fiscal Responsibility Act* and the *Employment Contracts Act* provided a vehicle for forcing previously recalcitrant departments to undertake changes in accounting, performance specification, financial management and employment practices. For example, during the early to mid-1980s there had been attempts, through Treasury guidelines, to encourage departments to keep asset registers and adopt accrual accounting but a number continued to disregard these suggestions. Under the *Public Finance Act*, and the related *State Sector Act*, which made chief executives of government departments responsible for financial management, accounting reform was forced upon them. Legislation also helped to ensure the continuation of the momentum of the accounting changes, notably the extension of accrual-based financial statements to the aggregate level, under the National Government.

Coherence and consistency. New Zealand's experiences in the early 1980s of *ad hoc* tinkering with management systems in central government led for the most part to incomplete or inconsistent changes. Scott *et al.* (1997) argue that a coherent framework helped to integrate the various aspects of the reforms – restructuring, performance agreements, incentives, human resource management, industrial relations and collective strategizing, and accrual accounting, budgeting, and reporting – in a mutually reinforcing manner. It also helped in quickly addressing new issues as they arose and in ensuring consistency, where appropriate, across the public sector. The introduction of strategic management should enable new ideas to emerge and keep the framework responsive to changing circumstances. However, it is equally important that a theoretical framework is not applied too rigidly and that it be allowed to evolve or be replaced over time. Efforts to force all state entities into the same mould (to assume "one size fits all") has been, and will probably continue to be, problematic.

There are implementation advantages in being comprehensive. In particular, it promotes consistency. Scott *et al.* (1997) argue that it was only by tackling all parts and all aspects of the public sector that significant gains were achieved. This is because all systems are strategically aligned and provide a consistent set of incentive signals. In New Zealand, comprehensiveness is apparent in two respects. First, the reforms tackled both the public and private sectors, all levels of government, and all functional sectors. The new SOEs would not have been able to operate as competitively without deregulation of the private sector. The momentum of the central government reforms meant that local government reform could be swept up and carried along with it. Second, the reforms tackled all sub-systems within the state sector. For example, the *State Sector Act* and the *Public Finance Act* formed an integrated package dealing with both the personnel and financial systems. Improved information about costs or assets is of no value if managers lack the authority to act. Sophisticated accounting systems are of no value if the department cannot attract suitably qualified staff. New Zealand also aligned its budgeting and its reporting systems so one could be used to monitor the other. This seems obvious, but is apparently unusual; in many countries financial reports cannot be compared with budgets without complicated further manipulations of figures.

Ordering of changes. An important implementation factor in the New Zealand case was the ordering of the innovation process. For example, successes with the SOEs were demonstrated before the model was applied to the core public service. Accrual accounting was established in individual government departments before introducing it at the whole-of-government level. Budgeting on an accrual basis could be introduced once a level of comfort with the financial statements being on a full accrual basis was established.

The New Zealand experience suggests that there were advantages in starting with outputs rather than outcomes despite the criticisms levelled at the initial focus on outputs. One reason is that it more closely parallels the private sector and hence provides models of management and implementation upon which to draw. For example, when the Audit Office was confronted with the requirement to audit non-financial performance information, there was no experience elsewhere in the world on which it could draw. By focusing on the reliability of information regrading the quantity, quality and cost of outputs, it was able to apply very similar audit techniques to those used in private sector audits (Pallot, 1999). Having gained confidence in auditing non-financial information it was then able to turn its attention to the *appropriateness* of performance measures which extends into the realm of longer term outcomes. A second reason is that New Zealand had an urgent need to deal first with its fiscal situation. Appropriating and budgeting by outputs, rather than by aims, objectives or programs enables a more transparent targeting of expenditure. It is easier to relate resources consumed to services produced than to relate costs to outcomes. Third, it makes sense to have some idea of what one is currently doing in fact before entering debates about whether one should be doing it whether something else should be done instead. In other words, if it is unclear what outputs are being produced debates about outcomes, or SRAs, will be poorly informed.

The later strategic phases have been able to build on the achievements of the preceding marketisation phase of reform. The new performance management framework had addressed the problem of confused objectives and clarified accountabilities. The new era of devolved management established a more innovative culture, open to new ideas (including ideas from the private sector). It is unlikely that the new strategic approach would have taken root had departments not already broken out of the bureaucratic command-and-control mentality. The strategic management system also builds on vastly improved information in terms of both quality and flow. Regular, reliable and strategically relevant information flows are needed for early identification of issues, to provide a sound basis for strategic decisions and for oversight of overall performance. Information on the quality, quantity and cost of outputs has better enabled ministers to make choices between outputs and assisted them in ordering priorities. Within departments, the quality of information and the ease of its flow have been enhanced by the streamlining of management structures.

Speed. Once a decision has been made to change, there are advantages in acting quickly. It prevents resistance to change from building up or loss of staff morale when decisions are uncertain. Once a momentum for change has built up, it is easier (at least for a few years) to make further changes. This means that not all problems will be ironed out in advance but much can be learned, and much progress can be made, simply by embarking on the process. This was the case, for example with some accounting issues (*e.g.* the valuation of infrastructure and heritage assets, the reporting of future liabilities for welfare payments, the timing for recognition of taxation revenues) which were difficult because there was virtually nothing in the way of established practice for accrual accounting by sovereign governments (Audit Office, 1993; Pallot, 1994). While further work on these issues continues, the experience in New Zealand was that more progress was possible by making a start in the first place than by trying to solve all theoretical problems in advance.

On the other hand, there are some disadvantages in proceeding too quickly. First, mistakes will be made (for example, in restructuring) which will generate further need for change. In a country with a small pool of expertise, this may result in undue stress ("burnout") of those most intensively involved.

Second, there may public backlash against the lack of consultation; it has been suggested (Nagel, 1993) that this was a sentiment behind the public's vote in 1993 to change the electoral system. Overly rapid change may be most resented in areas of personal interest to citizens; for example health, education and social welfare.

4. Concluding assessment

Any attempt to evaluate the central government reforms in New Zealand should probably be carried out in their own terms – that is, whether they have contributed to a more efficient, effective and responsive state sector – rather than in terms of their impact on the New Zealand economy and society as a whole. Admittedly, some of the same underlying philosophies have been applied outside the state sector, and it is also possible that the reforms lead to better policy-making. To this extent, there may be a link between the state sector reforms and the performance of the New Zealand economy and the quality of life in its society. To evaluate the reforms themselves in those terms, however, is extremely problematic for several reasons.

First, it must be remembered that the state sector reforms were only one component of a whole host of other economic and social initiatives undertaken since 1984. It is therefore impossible to isolate the effects, positive or negative, of the state sector reforms described in this paper from deregulation, the removal of tariffs and subsidies, tax reforms, legislation in social areas, labour market reforms and so on. Even if we focus more narrowly on public expenditure (for example), much of the deficit reduction can be attributed to improved public sector productivity, and hence higher revenue, plus reduced interest costs. Furthermore, New Zealand is a very small and open economy whose performance is highly dependent on circumstances and events in the rest of the world. The experience of the Muldoon era showed that New Zealand is not able to successfully insulate itself from the rest of the world as a larger country might be able to do.

Second, there is no clear benchmark against which the policies adopted in New Zealand can be assessed. Nor is it possible to known what would have happened if the reforms had not taken place. Comparing New Zealand's performance against a country like Australia which is inherently much wealthier is not appropriate. Another problem is that it is impossible to obtain consistent trend data amidst radical restructuring and changes to the bases of measurement; indeed one of the objectives of reform has been to overcome deficiencies in information previously available.

The absence of counterfactuals is a pervasive problem in trying to evaluate the reforms. Critics of the reforms argue that the economic reforms of the late 1980s first sent New Zealand into recession and that the improvement in economic performance apparent by the early 1990s at best put New Zealand back where it would have been in any case. Proponents of the reforms argue the reverse: that New Zealand's economic position would have been considerably worse without the reforms.

Limiting the debate to the state sector itself, and the financial management regime in particular, a number of benefits appear to have been obtained. The PFA has meant a shift from detailed centralised *controls* over *inputs* to ministerial *control* over *outputs*. Performance is now viewed in terms of results rather than cash spending. With improved control over *what* departments do, ministers can feel relaxed in giving departments freedom to decide *how* they do it. Having discretion over the choice of inputs contributes to better performance because decisions (such as whether to acquire, replace or dispose of assets) can be made by people with first-hand knowledge of the assets. Being freed from centralised input controls has had beneficial effects on motivation and helped to attract good managers (*e.g.* from the private sector) who had hitherto been discouraged by the extent of detailed administrative controls. Decentralisation of accounting systems and the shift to accrual accounting have also improved the information available to departments for the management of debtors and creditors. Savings from improved cash management (including better accounting for, and use of, supplier credit and improved debt collection) were some of the earliest benefits to be realised from the reforms (Morris, 1995). Ministers believe that they are able to make more informed choices about outputs and there is less tendency to think of expenditure in terms of existing organisational structures. They are now in a better position to target their expenditure and it is no longer necessary to employ crude mechanisms like "across-the-board" expenditure cuts. Correspondingly, select committees feel able to ask questions more relevant to what departments and ministers are trying to achieve.

Some of the less satisfactory aspects of the way in which the new financial system has been applied, such as the lack of information on outputs and lack of attention to possible running down of capability have been identified in the Auditor-General's report described earlier. Ultimately, however, the relevant question may not be whether the changes made measure up to some ideal but what would have been the costs of *not* changing. That is unknown, but amongst public sector managers themselves there has been little enthusiasm for returning to old systems and practices.

It is seldom that one country's governmental practices can be readily transposed into another jurisdiction. Differences in constitutional structures and conventions, size, political culture, administrative ethos, available technology and bureaucratic expertise all make the transfer of systems and ideas anything but straightforward. Countries will differ in their motivation or readiness to change. New Zealand is a small country which is always likely to be a niche player in the global market place and as such has a compelling need to be able to adapt quickly and respond to new ideas and opportunities. For the New Zealand Government, this makes strategic thinking and adaptive capacity a matter of critical importance (Fancy and Matheson, 1995, p. 6). Other countries may have a lesser need for adaptive capacity. Nevertheless, governments are constantly seeking new "technologies" to assist their priority-setting, and the recent SSC and Audit Office reports suggest that some of the newer thinking in the private sector could have application in government. Accordingly, New Zealand's recent experiences with state sector reform bears close scrutiny by policy-makers in other jurisdictions.

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NOTES

1. This is an extension of the phases identified by Pallot (1998).

2. These are all economic theories based on the assumption that individuals pursue self-interest. Public choice theory argues that while the pursuit of self-interest in the economic market place usually leads to socially desirable outcomes, similar behaviour in the political arena (sometimes also called political marketplace) can have damaging consequences. Agency theory views social and political life as a series of contracts in which one party (the principal) enters into exchanges with another party (the agent). As the interest of the principals and agents are likely to conflict, research based on agency theory focuses on finding the most satisfactory way of negotiating, writing and monitoring contracts so as to deter the agent's behaviour that is contrary to the interest of the principal. Transaction cost analysis examines how organisations and other arrangements are created to minimise the cost of doing business. Managerialism assumes that management is a generic activity that many concepts and techniques can be applied equally to the public sector as to private sector business.

3. As New Zealand is a constitutional monarchy, the state is referred to as the "Crown". Thus there are Crown companies, other Crown entities, and property held by the Crown. Financial statements covering the whole government are called "Crown financial statements".

4. Mixed Member Proportional (MMP) representation is a system in which half the seats in Parliament are decided on an electorate basis and the arrest are chosen from political party lists so as to make the number of seats for each party in proportion to the number of votes received for each party. The significance of the change is that single party majorities become less likely and the need for coalition more likely because there are more parties in Parliament.

5. For a more detailed discussion see Pallot (1996).

GOVERNMENT BUDGET AND ACCOUNTING REFORMS IN THE UNITED STATES
BY
JAMES L. CHAN[*+]

1. Introduction

American public budgeting and accounting is profoundly influenced by the federal system provided for by the United States Constitution. The federal government has its own fiscal laws and institutions. Federal budget rules are mostly codified in statutes and administrative regulations. Federal accounting rules are promulgated an advisory board sponsored by the principal federal fiscal officers and recognised by the auditing profession. Each one of the states has its own fiscal laws and institutions, which govern the state government itself and the local governments within its jurisdiction. Each state's budgeting practices are largely determined by its own laws and regulations, although a national advisory board has recently issued some voluntary guidelines. Professional influence has traditionally been much stronger in financial accounting for state and local governments. While these governments retain the legal authority over their accounting systems and internal reports, their external financial reporting has been subject to standards promulgated by complex institutional structures that combine technical expertise with a wide-range of political, economic and professional interests. In keeping with the federal and state/local distinction, the budgeting and accounting reforms at these two levels of government in the United States are addressed in separate sections of this paper.

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The paper also observes the distinction between budgeting and accounting. Budgeting precedes accounting chronologically and provides accounting with the benchmarks to measure financial performance. The accounting system has other functions besides monitoring budget execution. One function is to provide data for the fair presentation of the government's financial position and operations to external users. Under the influence of this external orientation, government accounting and financial reporting has become more autonomous from budgeting. The separation has become so great that there now exist two distinctive professions and two bodies of knowledge. Consequently, budgeting and accounting are treated separately as well.

These lines of fragmentation create the four main sections of the paper (see Table 1). While there are differences among the 50 state and approximately 87 000 local governmental units, only the general pattern in the state and local government sector is covered in this paper. In case close examination magnifies the differences among the four cells in Table 1, the concluding section will attempt to detect some signs of harmonisation.

Table 1. **The structure of American Government budgeting and accounting**

	Budgeting	**Accounting**
Federal government	(1)	(3)
State and local sector	(2)	(4)

American public budgeting and accounting reforms have focused on changing institutions, processes and policies. An institution may be viewed as a coalition of interested parties working together to achieve a particular purpose. Coalition building is especially necessary in the American political system and government, because of the separation of powers and the extensive checks and balances between the legislative and Executive branches of government. Conflicts are almost inevitable not only because of differences of opinion, but they also result from the tendency of institutions to preserve their prerogatives in the governance structure. In order to mitigate the dysfunctional consequences of political conflicts, processes have been designed and changed to facilitate consensus building in policy-making in budgeting and accounting. Budgeting policies refer to the rules for the preparation, approval and execution of a budget. The term "budget policies" is reserved for decisions that affect the allocation and financing of the budget. We will focus on accounting policies promulgated by standard-setting boards, and not the rules of the thousands of state and local jurisdictions. In the United States, these policies include both measurement and disclosure rules that govern the form and content of financial reports, but do not prescribe systems and other means of implementation, *e.g.* the charts of accounts.

2. Federal budgeting reform

2.1. Introduction[1]

The budget of the federal government, accounting for almost one-fifth of the Gross Domestic Product (GDP) of the United States, is heavily influenced by both political and economic considerations. It is directly governed by a number of public laws that formally designate the decision-makers, prescribe their roles and, in recent years, specify its targets. This section examines federal budgeting reform in terms of the changes in the legal framework that provide for the institutions, processes and policies.

There are two types of federal budgeting laws. *Process-oriented* laws designate the players, assign their roles and specify the rules of the budgetary game so that the President and Congress can reach compromises more or less in time to keep the government functioning each fiscal year. The specific legal provisions reflect the political consensus regarding the proper sharing of the power of the purse. By and large, these laws have succeeded in erecting a relatively stable institutional framework for proposing and approving the federal budget. When disputes of a constitutional nature arise, the federal judiciary steps in to settle them when law suites are brought. The *outcome-oriented laws*, on the other hand, have been designed to achieve deficit reduction. Recent history shows they have had less predictable and successful results. In view of the complex interactive relationship between the federal budget and the economy, lower budget deficits cannot be preordained by law. Deficit reduction requires the facilitation of a strong economy that generates abundant government revenues.

There is another way to look at federal budgeting laws. The pre-1980 laws sought to exert *budgetary control*, while the post-1980 laws aimed at *controlling the budget*. Legislative budgetary control is reinforced by the machinery of government, including a compliance-oriented accounting system. It is, in short, an intra-governmental matter. In a mixed economy, controlling the budget – both on the revenue and spending sides – is much more difficult. Much depends on favourable economic conditions and the American public's attitude toward the role of government in the economy and in their lives. The federal budget is many things to many people. It is not only the government's financial plan. In the final analysis, it is the nation's blueprint for resolving conflicting values.

A remarkable feature of federal budgeting is the permanency of the institutions. New institutions were added, but old ones seldom faded away. This makes it difficult to understand the current or recent reforms without knowing past efforts. Similarly, it is also impossible to separating institutions, processes and policies. Institutions drive processes, which produce or are guided by policies over time.

2.2. The Constitution and early practices

The Constitution of the United States is rather concise with regard to the federal government's finances. It gives Congress the power to levy taxes and requires appropriations made by law before funds may be drawn from the Treasury. However, the Constitution does not provide a blueprint of the way in which Congress should exercise this power, nor does it assign a formal role to the President. Congress created a committee structure and devised rules to carry out its budget responsibilities. In the first half of the 1800s, these were handled mainly by the House Ways and Means Committee and the Senate Finance Committee. After the Civil War, both Houses of Congress set up Appropriation Committees. This arrangement enabled the House Ways and Means Committee and the Senate Finance Committee to concentrate on revenues. Congress also enacted the Anti-deficiency Act to regulate budget execution by: *i)* requiring apportionment – the allocation of appropriation by time period – to prevent overspending; *ii)* prohibiting government officials from incurring obligations in advance of appropriations; *iii)* forbidding spending in excess of appropriations or for purposes unintended by the appropriations. These injunctions remain the cardinal rules for fiscal conduct of federal government officials.

The early federal budgeting system permitted executive agencies to request funding from congressional committees without the President's control or even policy guidance. This practice continued until the early 1900s and caused President William Howard Taft to appoint a Commission on Economy and Efficiency. The commission observed and the President agreed on the need for a "national" budget, meaning one that covered the entire federal government. This precipitated a lengthy debate that eventually led to the passage of a comprehensive budget law for the federal government.

2.3. Foundation of the federal budgeting system

The legal foundation for the federal government's present budgeting system was laid initially in 1921 and modified in 1974 to redress a perceived imbalance of power. Two laws provide a stable institutional framework for preparing the ever weightier federal budget to meet ever expanding U.S. commitments at home and abroad during most of the 20th century.

Budget and Accounting Act (1921). Though 80-years old, the Budget and Accounting Act of 1921 retains a contemporary outlook because the system and institutions it established are still functioning. The act requires the President to submit a budget on behalf of the entire Executive branch and provides him with a budget staff to carry out this responsibility. All American presidents took advantage of the budget to set priorities, co-ordinate actions, and enforce policy. In the 1930s, President Franklin Roosevelt, recognising the value of the Bureau of the Budget, moved it from the Treasury Department to the Executive Office of the President. Later, President Richard Nixon expanded the agency's scope and renamed it the Office of Management and Budget.

Congress was quite specific about the information content of the budget in summary and in detail: appropriations requested and proposed revenues; estimates of expenditures and receipts for the budget year and the current year; the current year's appropriations; levels of indebtedness; past, current and projected financial condition of the Treasury; and other information about the financial condition of the government. The President is further required to explain how he intends to handle any budget surpluses or deficits, and is permitted to request supplemental appropriations. Federal agencies are required to comply with the President's information requests issued through the Bureau of the Budget.

The act's prescription for submission of the President's budget and the information contained therein has become a part of the permanent United States Code. While the dates and some details have changed, the essence of the system has remained intact. It is remarkable that the act envisioned an integrated (prospective) budget and (retrospective) accounting information system that the federal government is still using and enhancing.

During the next 50 years after the 1921 Act, the federal budget grew enormously as the federal government expanded its economic and social welfare functions domestically and acquired global military power. It also became a major fiscal policy tool of the Keynesian revolution in economic thinking about the government's role in managing the economy. It financed President Franklin Roosevelt's New Deal programs and America's expenditures during and after World War II. It similarly paid for President Lyndon Johnson's figurative War on Poverty and the real war in Vietnam. By the time President Richard Nixon assumed office, the power of the presidency had reached a historical height. Frustrated by having to fund an undeclared and unpopular war and by large presidential impoundment of funds over policy differences, Congress decided to reassert itself.

Congressional Budget Act (1974). The Congressional Budget and Impoundment Control Act were intended to strengthen the legislature's role by enabling it to produce a master budget and equipping it with the necessary analytical capability for the task. On top of the existing revenue and appropriation committees, each house of Congress added a Budget Committee, and Congress as a whole gained a Congressional Budget Office (CBO). The centrepiece of the congressional budget process is the budget resolution, which sets ceilings for budget aggregate numbers. Procedurally, the act requires each standing committee of the House and Senate to review the President's budget proposal and recommend budget levels and legislative plans to the Budget Committee in each house. The Budget Committee then initiates the concurrent resolution on the budget to specify the desired levels for total receipts and for budget authority and outlays, both in total and by functional category (such as national defence, agriculture). As a direct consequence, the levels of budget deficit and debt are both set. The budget resolution allocates amounts of budget authority and outlays within each functional category to the committees having jurisdiction over the programs in each function. The Appropriation Committees are required to allocate the amounts to their constituent subcommittees. The budget resolution often contains reconciliation directives that instruct authorising committees to change the permanent laws affecting taxes and other receipts as well as entitlement programs in order to meet the goals contained in the budget resolution.

Upon the completion of Congressional action and the President's signature, the administration is charged with the faithful execution of the budget. Sometimes, the President declined to spend – or impounded – appropriated funds. Presidents may impound funds only under limited circumstances such as to provide for emergencies or to achieve savings. The Nixon Administration impounded funds on a massive scale and in order not to carry out policy objectives sanctioned by Congress. In response, Congress passed the Impound Control Act of 1974. The act requires the President to send special messages to Congress whenever he wishes to rescind or defer appropriated funds. For a proposed rescission to be effective, both the House and Senate must approve it within 45 days of continuous session. A presidential deferral takes effect and remains so unless it is overturned by an act of Congress.

In summary, budgeting is an unavoidable perennial political struggle, because without appropriations the federal government shuts down. The political price of public wrath over that outcome is high enough to encourage pragmatic compromises. The present federal budget system is the result of almost a century of returning the delicate balance of power between the Executive and the legislative branches. Even though the President enjoys the advantage of initiative afforded by the 1921 Act, Congress strengthened its institutional capability and created the vehicle for converting budgeting from an exercise of accumulation to one of division. These budget process “reforms” are essentially alterations in power-sharing agreements between the President and Congress. The next section describes another type of reform, one that sought to increase the responsiveness of the budget to Presidential leadership and policy.

2.4. Budget preparation reforms

In order to counter the insatiable appetite of the bureaucracy for ever-larger budgets, American Presidents from time to time exerted top-down control by decreeing new budget preparation methods. These do not require congressional approval. The most publicised efforts were President Johnson’s Planning, Programming and Budgeting System (PPBS) and President Carter’s Zero-Base Budgeting (ZBB).

The traditional federal budget at the present time consists of line items of proposed expenditures with appropriations by budget accounts and in terms of agencies. Such a budget format reflects the tight control of Congress over the administration. It tells what the government agencies are authorised to buy, such as personal services, materials, supplies, contractual services. PPBS challenged this annual, incremental line-item budgeting system in two ways: *i)* it lengthened the planning horizon to multiple years; *ii)* it sought to align resource requests to programs, *i.e.* the activities undertaken to carry out policies and achieve priorities. Even though PPBS as such is no longer required, it is still used by the Department of Defence and elsewhere, and its spirit lives on. Currently fashionable techniques like performance measurement, activity costing, and mission-budgeting are in some ways the reincarnation of the essence of PPBS.

The other budget preparation reform, ZBB, was conceived as an antidote to incrementalism, a budget practice that treats the previous year’s base as given and focuses attention to the addition. In the extreme version of ZBB, nothing was sacred from budget cuts. Agencies were requested to justify every penny. Priority-setting was enforced through the ranking of requests called “decision packages”. Eventually ZBB collapsed down the weight of the paperwork it generated and did not survive longer than the Carter Administration. Similar to what happened to PPBS, the spirit of ZBB was revived in the Clinton Administration's National Performance Review, an exercise aimed at making government leaner and more effective.

In brief, reforms may be episodic but some of the basic values lived on. The current implementation of the Government Performance and Results Act, which requires strategic planning and output-oriented performance measures, echo the basic tenets of PPBS and ZBB. The other historical lesson is that no matter how rational and sophisticated the manner of preparing and justifying a budget, it did not prevent Presidents from submitting, and Congress from appraising, deficit budgets.

2.5. Deficit reduction measures

From 1969 to 1997, the federal government ran continuous budget deficits. As early as the 1970s, there was already concern over the effects of "uncontrollable" social welfare entitlement expenditures. However the amounts of deficits remained relatively small until the early 1980s. By then President Ronald Reagan's twin success in securing substantial tax cuts and increasing military spending pushed federal budget deficits to unprecedented levels. Congress reacted by making deficit reduction an explicit goal of budgeting laws, beginning with the Balanced Budget and Emergency Deficit Control Act of 1985.

Balanced Budget and Emergency Deficit Control Act (1985). Commonly called the Gramm-Rudman-Hollings Act, the Balanced Budget and Emergency Deficit Control Act of 1985 set out to balance the federal budget by 1991 by fixing progressively smaller deficit targets in the intervening years. If the projected budget deficit exceeded the specified target by more than the amount permitted, the cancellation of budget resources, called sequestration, would be triggered. The law was amended in 1987 to extend zero deficit targets to 1993 and to transfer the responsibility of determining sequestration trigger-point from the Comptroller General to the director of the Office of Management and Budget. History shows that, despite the threat of sequestration, the federal government continued to run budget deficits in each of the fiscal years covered by the law.

Budget Enforcement Act (1990). Since the 1985 and 1987 laws were unable to achieve their deficit reduction objective, Congress decided to try a different process through the Budget Enforcement Act (BEA) of 1990, which was extended several times. The chief innovation of the BEA is its recognition of the different nature of discretionary programs subject to annual appropriations and mandatory programs authorised by permanent laws.

Discretionary spending, such as agency operating budgets, requires prior program authorisation by legislative committees and requires annual appropriation. The BEA sets dollar limits or “caps” on the total budget and on authority for discretionary programs. The caps are adjustable annually for: *i)* the difference between the actual inflation rates and the rates used in setting the discretionary caps; and *ii)* for emergency appropriations. Budget resolutions allocate budget authority and outlay amounts for discretionary spending. These amounts are further subdivided by appropriation committees to their subcommittees. If the appropriation acts for a year provide the amount of budget authority greater than the cap on budget authority, or if the amount of outlays associated with the budget authority is greater than the caps on outlays, the BEA calls for sequestration, or across-the-board cuts by a uniform percentage of most discretionary programs.

Unlike discretionary spending, spending for most entitlement programs – *e.g.* Social Security, health care for the elderly and the poor – are direct or mandatory because they are provided for in the laws that authorise these benefits to eligible individuals. Congress intentionally exempts these programs from the scrutiny of the annual appropriation process. The BEA does not prohibit spending increases for any discretionary program. It does, however, insist that such increases caused by legislation be deficit-neutral. That is, the increases will be “paid for” by decreases in some other program or by raising revenues. This compensatory mechanism is described as pay-as-you-go (PAYGO). Similar trade-off requirements apply to revenues: legislation decreasing one type of revenue must be fully offset by legislated increases in other revenue sources, or legislated decreases in mandatory spending. Change in mandatory spending or revenue caused by outside factors such as the growth of retired population or the expansion of taxable income are recognised but not subject to those types of control.

It appears that the BEA, reinforced by political leadership and facilitated by favourable economic conditions, had a measure of success in reducing the federal budget deficit and converting it into a surplus. The experience with GRH and BEA shows that budget deficits are reduced by political will, not by setting unrealistic goals. The threat of sequestration was not credible because Congress could – and did – undo the GRH Act’s fixed deficit reduction targets. These were replaced by BEA’s discretionary caps and PAYGO procedures. The more flexible and discerning approach of the BEA probably contributed to its successful implementation. The larger explanation may lie in the public’s heightened sense of the approaching day of reckoning. When the electorate elevated deficit reduction to a priority, both Democrats and Republicans found the incentive to reach agreement to aim for zero deficit by the year 2002.

2.6. Lessons from federal budget reform

Several lessons may be drawn from federal budgeting reforms. First, the federal government had greater success in budgetary control than in controlling the budget, as evidenced by the 30 years of annual deficits. The federal government made itself worse off fiscally in order to make the public better off by providing politically popular benefits. Second, declaring fixed deficit reduction goals without considering the economy and the public expectations did not produce the desired outcome. Third, the conflicts and tensions in the budget process are the consequences of checks and balances, which have contributed to a moderate course of action. Fourth, projecting the costs of government benefits to recipients has become as important a budgeting exercise as deciding agency appropriations. Finally, changing budgeting institutions and processes did not necessarily deliver desired outcome, *i.e.* a balanced budget. The federal deficit or surplus depends greatly on the performance of the economy.

3. State and local budgeting reform

3.1. Introduction[2]

The federal budget preparation reforms described earlier have their roots in state and local governments, where budgeting reform has also been a continuous process. For example, New York City experimented with performance budgeting in the early 1900s and the state of Georgia tried zero-base budgeting in the 1970s. Even the Clinton Administration's Reinventing Government or National Performance Review effort was based on local governments' mission-driven budgeting. While the new tools and techniques have been similar at both levels of American Government, the evolution of their budget processes has been different. To understand and evaluate budgeting reform in state and local governments, it is important to recognise their distinguishing features.

American state and local governments are numerous and diverse. There are approximately 87 000 local government units in the 50 states. In addition to the multi-function general governments (*e.g.* cities and counties), there are single-function special districts that provide services such as elementary and secondary education, utilities, and parks and recreation. In general, these governments raise most of their own revenues, although the federal government provides considerable funding for some services, especially in urban areas. In the same geographical area, there are often overlapping jurisdictions that provide services, raise revenues, and borrow against the same tax base. Consequently while their services are complementary, they compete against each economically. This fragmentation has contributed to diffused accountability.

American local governments, as political subdivisions of the states, are subject to state laws regulating local revenue, spending and debt. They are often required to balance their budgets and are prohibited from borrowing money to cover deficits. Large local governments are often granted home rule with greater autonomy in fiscal matters. Property taxes are a main source of local tax revenue, while income taxes and sales taxes are the major state revenue sources. In order to limit tax increases, both state and local governments have increasingly resorted to more and higher user fees. Compared with the gederal government, there is a greater correspondence between the taxes and fees paid and services received. Federal grants and contracts enable state and local governments to provide most of their health and social services to the poor.

State and local governments commonly have separate operating budgets and capital budgets. Subject to applicable debt limitations, they are generally allowed to issue bonds to finance capital projects. Private-sector bond rating agencies, such as Standard & Poors and Moody's Investors Service, evaluate the creditworthiness of the borrowers. Bond rating agencies consider, among other factors, the quality of management in determining bond ratings. As higher bond ratings lead to lower interest costs, governments have the financial incentive to improve their budgeting and financial management practices.

The budgeting systems of state and local governments share some common features. Their budget processes are generally led by the chief executive, who is assisted by a central budget office. Their operating budgets fund current services and are financed from current revenues, whereas their capital budgets are mostly financed by debt and intergovernmental grants. Under balanced budget laws, local governments must limit proposed expenditures to projected revenues. Deficits are to be financed through reserves or a combination of tax increases and service reduction. Finally, citizens have the right to examine government budget proposals, and to attend and speak at public hearings on local government budgets, although in practice they are often represented by interest groups or civic associations.

These practices are the results of reforms over a long period of time as discussed below.

3.2. Institutional reform

Nearly all of the institutional reforms in state and local budgeting occurred in the early decades of the 20th century. During that period, social reformers, often the business elite in major cities, sought to root out official corruption and reduce political patronage in municipal governments. They saw better budgeting as a way to improve government management. Reformers proposed the separation of administration from politics, for example, by creating the position of city manager, which requires professional qualifications and political neutrality. The demand for greater government accountability also led to the centralisation of management and the assignment of fiscal responsibility to the chief executive, such as the mayor or city manager. The chief executive was to prepare and present a budget for debate and modification by the legislature. The implementation of the approved budget would be the responsibility of the administration. Also during this period, there was greater division of labour in the finance function. Budgeting and accounting became separate functions. The tradition of independent audit was also established. This basic pattern of accountability, characterised by separation of powers and checks and balances, continues to this day in most state and local governments.

In the succeeding decades, this basic governance structure proved to be strong and flexible enough to accommodate other efforts to improve budgeting policies and processes.

3.3. Policy and process reforms

During the Great Depression in the 1930s, some state and local governments defaulted on their bonds due to reduced tax revenues but were still pressed to provide essential services. This created demands for better cost accounting methods and the use of performance measurement. In 1935, the Municipal Finance Officers Association (MFOA) advocated performance budgeting as a way to bring cost accounting data into the budget process. Fiscal problems also exposed weakness in budgeting and accounting procedures and the improper use of debt. State governments passed laws to restrict local borrowing and to require balanced budget and adherence to stricter accounting procedures.

The next major wave of budgeting reform occurred in the 1960s. As in the federal government, state and local governments experimented with the use of the budget as a planning tool. Initially, performance budgeting – tying dollars to agency performance – was advocated and was combined with cost-benefit analysis to become the Planning and Programming Budgeting Systems (PPBS) system. In contrast to operational management and control, PPBS emphasised longer term planning and the clear identification of activities as a basis for resource allocation. The hope was that the comparison of costs and benefits would increase the rationality of budget allocation.

PPBS was succeeded by ZBB in the mid-1970s. While ZBB is identified with the federal government, it was first introduced into the government of the state of Georgia by then Governor Jimmy Carter. Its advocates saw ZBB was a tool to fight against incrementalism in budgeting. When government agencies took their current year's base for granted, policy-makers encountered difficulties in changing priorities and finding discretionary resources for new programs. Under the incremental budgeting system, legislatures similarly could only play a compliant role when review was limited to requests for additional amounts. Thus political leaders used ZBB to overcome bureaucratic inertia to change at a time when many local governments were facing fiscal strain. Fiscal crises forced governments to find ways to cut spending when raising revenue was no longer possible due to citizen propositions and referendums to impose limits on property tax. Such a climate was receptive for a new approach like ZBB, since it compelled government managers to justify the use of resources. However, when it was taken to the extreme of requiring justification for every budget dollar every year, the burdensome paperwork and time-consuming deliberations overwhelmed the capability of governments. The stress, need for sophisticated information, as well as the short-lived ZBB experiment became a symbol of impractical budgeting reform.

As in the federal government, even though PPBS and ZBB were abandoned as formal budgeting systems in most state and local governments, the need for strategic direction and rational economic choice remains. As these governments faced recurring pressures to cut spending, they responded by new techniques such as contracting out services and greater use of information technology ("electronic government"). This new breed of reform comes under the label "Reinventing Government," which is also the title of a popular book by Osborne and Gaebler. As their predecessors did, the current generation of reformers decry the dysfunctional bureaucracies and sought to give purpose to government. Their preferred budget tool is a results-oriented budgeting system that holds government accountable for accomplishments. This and other techniques are presumptuously labelled "best practices" by consultants eager to sell governments new solutions to old problems. Many of the prescriptions of *Reinventing Government* soon formed the basis for a federal initiative called the National Performance Review initiated by Vice-President Gore in the Clinton Administration. Upon closer examination from a historical perspective, this mission-driven and output-oriented budgeting bears a strong resemblance to PPBS and ZBB.

3.4. Lessons from state/local budgeting reforms

What lessons can be learned from a century of budgeting reform in American state and local governments? Some of them are captured in the *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting* recently identified by the National Advisory Council on State and Local Budgeting (NACSLB). Formed by the Government Finance Officers Association and seven other major public interest groups, the council issues what amounts to generally accepted budgeting principles. Since American governments have the legal authority to determine their own budgeting practices, the council's recommended practices would complement but not replace budget laws and regulations. In recognition of the variation in size and complexity of American state and local governments, the council's recommendations are general. For example, according to the NACSLB, a "good" budget process:

1. incorporates a long-term perspective;

2. establishes linkages to broad organisational goals;

3. focuses budget decisions on results and outcomes ;

4. involves and promotes effective communication with stakeholders; and

5. provides incentives to government management and employees.

A major recommendation of the council was to involve *all* stakeholders – people with vested economic and political interests – in the budget process. While widespread participation might heighten conflict, the NACSLB believes that in the long run stakeholder involvement would lead to greater acceptance of budgetary decisions, which inevitably involves hard choices. Box 1 describes the 12 elements of a good budget process, which are elaborated by specific practices to provide guidance.

Box 1. The 12 elements of the budget process[3]

Establish broad goals to guide government decision-making

1. Assess community needs, priorities, challenges and opportunities.
2. Identify opportunities and challenges for government services, capital assets and management.
3. Develop and disseminate broad goals.

Develop approaches to achieve goals

4. Adopt financial policies.
5. Develop programmatic, operating and capital policies and plans.
6. Develop programs and services that are consistent with policies and plans.
7. Develop management strategies.

Develop a budget consistent with approaches to achieve goals

8. Develop a process for preparing and adopting a budget.
9. Develop and evaluate financial options.
10. Make choices necessary to adopt a budget.

Evaluate performance and make adjustments

11. Monitor, measure and evaluate performance.
12. Make adjustments as needed.

3.5. Summary on American public budgeting reform

American governments have engaged in four major types of budgeting reform: *i)* budget execution reform; *ii)* budget preparation reform; *iii)* budget institution and process reform; and *iv)* deficit reduction reform.

The goal of budget execution reform has been to make sure that public spending was legal and not wasteful. This kind of reform, usually initiated by the legislature, entailed improved financial record keeping, legal compliance audits and stringent internal control. Legislatures specified detailed line items in the budget and included specific restrictions in appropriations to limit administrative discretion. Thus legal compliance amounted to administrative obedience to legislative will. Budget execution can also be viewed from an economic perspective. American government auditing has long expanded to cover the evaluation of the economy, efficiency and effectiveness of government programs and operations. Such evaluations could not be confined to an examination of government operations; they often touched on the controversial issue of the scope and function of government. For instance, when more than half of the annual federal budget expenditure goes to providing social welfare benefits to individuals, value judgements permeate the evaluation of social programs.

Budget preparation reform attempted to marshal budgetary resources to achieve goals and carry out policy priorities. This kind of reform, typically initiated by the administration, steered budget discussions and requests to address the basic question: what is the money for? Sometimes new measures such as functional classification of spending are misinterpreted to be substitutes for the traditional line-item budget. They actually represent different ways of looking at the same dollar. Furthermore, they were built on the foundation of basic budgetary discipline. Otherwise, lump-sum appropriations would be an invitation to corruption, fraud and abuse.

The third type of reform changed the governance structure for making budgetary decision so that the pendulum of budget power settles near the centre. Historically, this kind of reform was undertaken in response to the dominance of one branch of government over the other. Many analysts have observed the political nature of the American government budget process. This is a natural consequence of the separation of powers, and of the checks and balances envisioned by the framers of the Constitution. The political struggles of competing forces prevented excesses from going on for too long and or doing lasting damage. This has accounted for the durability of the basic institutional framework over the past century.

The fourth type of reform aimed at reducing budget deficits. Most state and state governments have long been constrained by balanced budget requirements in constitutions or statutes. Lacking the power to print money, their deficits are limited by the willingness of the private-sector capital market to lend them money. The federal government is different. It can print money and its ability to borrow is finite but virtually limitless. Its awesome economic power, however, is matched by its unique responsibility for national defence and general welfare. When federal budget deficits reached hundreds of billions of dollars, Congress reacted by introducing fairly draconic measures such as across-the-board cuts if deficit reduction targets were not met. History has shown that those legislated targets were ineffectual. It took the capping of discretionary programs and forced trade-offs to bring the budget deficits down. While the government cannot be blamed for Americans' seemingly insatiable appetite for government benefits and programs, it does not deserve full credit for the disappearance of deficits in the late 1990s and the emergence of projected surpluses in the first decade of the 21st century. Unexpected growth in productivity arising from information technology, along with judicious monetary policy, produced the results surprising even to seasoned budget watchers. The fates of the public budget and the economy are tightly intertwined.

Today public budgeting reform remains a lively topic but its meaning is no more precise than in the past. Budgeting reform was initially equated with installing basic expenditure control mechanisms and accountability. Later it was expanded to making the budget a meaningful tool for decision-making and planning. Now, it becomes a part of improving government performance. While this puts budgeting in a broader governmental and societal context, it does not reduce the necessity of choice, which is at the heart of budgeting.

In view of the enormous importance of the public budget not only to government, but also to the society and the economy, it is not surprising that politicians want to maintain tight control. Admitting the political nature of the budgetary process and acknowledging the supremacy of elected officials in creating budgeting laws, most budget experts work on as technicians serving the will of politicians. In contrast, public sector accounting has a long tradition of professional influence, especially in state and local governments, as will be discussed in the next part.

4. Federal accounting reform

4.1. Introduction

The U.S. federal Government has long had a functioning budgetary accounting system that keeps track of the spending of budgetary resources in terms of obligations and outlays. The Anti-deficiency Act prohibits federal officials and employees from making commitments or expenditures in excess of appropriations or for unauthorised purposes. The effect of this old law was strengthened in 1982 by the Federal Managers' Financial Integrity Act, which held agency heads responsible for sound internal control to prevent fraud, waste and abuse. Today there is increased realisation that managing the government entails more than strict budgetary control. Competent public officials and financial managers make decisions and carry out transactions and activities to accomplish agency missions. The seed of the current institutional structure to provide information for decision making and monitoring the transactions and activities were planted early in the 20th century.

As explained in Section 2, the basic architecture of the financial system for the federal government was established by the Budget and Accounting Act of 1921, which created the Bureau of the Budget (BOB) and the General Accounting Office (GAO). As evidenced the title of the law, Congress intended a close relationship between budgeting and accounting. However institutional prerogatives encouraged by the constitutional doctrine of separation powers and the assertion of presidential authority in resource allocation, soon led to the fragmentation of the financial system. The General Accounting Office, headed by the U.S. Comptroller General with a 15-year term, belongs to the legislative branch of government. The Bureau of the Budget was transferred from the Treasury Department to the Executive Office of the President. As a consequence, in the budgeting and financial management area, the Treasury Department was reduced to the federal government's cash manager and bookkeeper. In contrast, the BOB and its successor, the Office of Management and Budget (OMB), by virtue of their proximity to the President, were recognised as the leading player in budget allocation decisions. A similar pattern has existed in individual executive departments and agencies. The budget office dominated the resource allocation process, and financial managers, including accountants, were relegated to secondary roles. This basic structure remained for several decades when the budget reforms dominated Washington. However latent tensions persisted.

American presidents since Franklin D. Roosevelt have regarded financial management, including accounting, to be an executive function that should be under the administration's control. However, Congress considered accounting policy to be an extension of its budget authority and oversight function. After all, the U.S. Constitution requires congressional appropriations before money can be drawn from the Treasury, which is required to provide periodic financial reports to Congress. Both of these requirements were used as justification for the legislative branch's involvement in making federal accounting policy. Specifically, the 1950 Budget and Accounting Procedures Act authorised the GAO to prescribe accounting rules and procedures to be followed by executive departments and agencies, whose accounting systems also had to be approved by the GAO. What Congress considered as its prerogatives was viewed by the Executive as legislative meddling in administration, leading not only to tensions but also potentially lost opportunity for improving the federal government's financial management.

Persistent and record levels of federal deficits, reaching close to $300 billion in fiscal year 1992, created a perception that the federal government's financial house was not in order. A sense of urgency emerged that more concrete actions were necessary than renaming the Bureau of the Budget as the Office of Management and Budget. In the 1980s, financial management, a routine bureaucratic function, became politically visible when frauds, waste and abuse were attributed to financial mismanagement. When investigations were conducted, a frequent finding was that the financial information from agency accounting systems was unreliable and inconsistent. This gave rise to the need for better federal accounting as part of improvements to federal financial management during the past decade.

4.2. Institutional reform

The creation of chief financial officers positions and the Federal Accounting Standards Advisory Board in 1990 provided the institutional foundation for policy reforms discussed in the next section.

CFOs.[4] The management side of OMB was strengthened by the 1990 Chief Financial Officers Act. The legislation designated a deputy director of the OMB as the Chief Financial Officer (CFO) for the entire U.S. Government and created similar CFO positions in executive departments and agencies. These officials form a CFO council for co-ordinating actions to improve financial management throughout the government. An Office of Federal Financial Management, headed by the Controller (not to be confused with the U.S. Comptroller General, who is head of the legislative audit office), was also established in OMB to spearhead the implementation of the act. The CFOs were charged with overseeing all aspects of financial management, especially the development and maintenance of integrated systems and the production of reliable financial information. The information would be used in part to prepare audited agency financial statements, whose form and content would be determined by the OMB and which would meet applicable accounting standards. These standards would be set through an interagency arrangement described below.

FASAB.[5] The 1990 CFO Act does not alter the traditional role of the Treasury in preparing the Annual Reports of the U.S. Government, or the GAO's status as the government's auditor. However, it added a complication to the already complex jurisdictional issue of who should set federal accounting standards. The act authorised OMB to determine the "form and content" of financial statements of federal agencies, but did not change the GAO's long-standing role in prescribing accounting standards. Fortunately, the secretary of the Treasury, director of the OMB, and the Comptroller General by 1990 reached an agreement to sponsor a Federal Accounting Standards Advisory Board (FASAB). The membership of FASAB was carefully calibrated to reflect the interests of all concerned: three from the sponsors, two from the federal agencies, one from the CBO, and three public (*i.e.* non-federal) members. Over the next decade, FASAB would recommend these officials to issue numerous accounting and reporting standards. The FASAB acquired greater stature and independence when its standards were recognised as generally accepted accounting principles by the AICPA in late 1999. At that time, the board's sponsors agreed to permit new FASAB standards to take effect unless they are vetoed by a sponsor during a 90-day waiting period.

4.3. Policy reform[6]

FASAB standards have affirmed the important role of accounting and financial reports in monitoring budget execution and in ensuring compliance and deterring fraud, waste and abuse. The board also believes that federal financial reports should assist their users in evaluating the operating performance of federal agencies, and in assessing the impact of the federal government's operations and investments on the financial condition of the nation. These objectives led the FASAB to recommend cost accounting standards in addition to financial accounting and reporting standards. Collectively the standards required the preparation and issuance of consolidated financial statements for the U.S. Government and its constituent component units under the full accrual basis of accounting.

Accrual accounting is not a new requirement for the federal government. As early as the 1950s, the Hoover Commission recommended accrued expenditures and this position was later supported by the President's Commission on Budget Concepts in 1968. The Bureau of the Budget and the Treasury Department attempted to implement the recommendation, but found that impractical. The FASAB's endorsement of the accrual basis has several new aspects. First, accruals would apply to the entire federal financial reporting model, and not selectively to particular programs or elements in the financial statements. Second, full accrual rather than modified accrual was recommended. This meant that the federal government's balance sheets would include present capital assets and long-term liabilities. Federal resources not recognisable as assets (*e.g*. national monuments) and federal responsibilities not recognisable as liabilities (*e.g*. social insurance benefits) would be reported separately in a "Stewardship Report." This approach acknowledges their importance and intractable conceptual and measurement problems.

The CFO Acts requires federal agencies to prepare, and submit for audit, financial statements for the entire organisation. The statements include: a balance sheet, a statement of net costs, a statement of changes in net position, a statement of custodial activities, a statement of budgetary resources, and a statement of financing. A statement of program performance measures is also required in compliance with another law. The experience at the agency level built the foundation for the release for the first time of audited government-wide financial statements for the fiscal year 1996. Even though the GAO issued a disclaimer with a long list of criticisms, it was a notable achievement in view of the size and complexity of the federal government.

4.4. Beyond accounting[7]

Federal accounting reform should be viewed in the context of cyclical waves of government management improvement reform. The results in the 1990s were made possible by activities in the previous two decades. During that period, GAO evaluations of government programs and operations often uncovered cost overruns and evidence of fraud, waste and abuse. Such information reinforced the popular American public distrust of government. Fighting waste in government is a favourite political campaign slogan to win public support for public office. Mounting deficits over three decades lent additional credence to the claim that the federal finances were out of control. Since accountants and auditors have a professional image of financial discipline and conservatism, their profile was raised in the latest round of financial management reform launched by the 1990 CFO Act.

Soon thereafter, the focus on finance was broadened to management by a series of legislation. In 1993, the Government Performance and Results Act required agencies to submit strategic plans and performance reports. The 1994 Government Management Reform Act required the audit of agency financial statements and the preparation and audit of financial statement for the entire U.S. Government. In 1996 the Federal Financial Management Improvement Act directed auditors to report on whether agencies were following systems requirements, accounting standards and the Standard General Ledger. These laws cemented a closer relationship between finance and management in general.

5. State and local accounting reform

5.1. Introduction[8]

As Section 3 indicated, each state, including its local governments, has its own fiscal institutions and laws. Even so, public finance professionals have been very influential in promoting good practices nation-wide. In the 1910s and 1920s, they sought to reduce corruption in municipal governments by advocating good financial record-keeping and other business practices. In the 1930s, the predecessor of the Government Finance Officers Association (GFOA) appointed a committee to codify municipal accounting practices. This effort continued intermittently for the next 30 years, resulting in a substantial body of professional guidance for government accounting, reporting and auditing in support of efficient financial management. After a series of municipal fiscal crises in the 1970s exposed poor accounting practices in some of the nation's large cities, changes were again made to the standard-setting institutional structure and to the accounting standards in order to improve the public accountability of government through full disclosure. These recent reforms are described below.

5.2. Institutional reform[9]

In 1974, the GFOA expanded its technical committee on accounting into a 21-member National Council on Governmental Accounting (NCGA). The NCGA drew its membership from the ranks of the fiscal officers of state and local governments as well as the federal government, the auditing profession, the financial investment community and the academe. The part-time members met monthly and relied on the GFOA for limited staff support. Around this time, a full-time Financial Accounting Standards Board (FASB) was established to set Generally Accepted Accounting Principles (GAAP) for business firms and non-profit entities in the private section. An arrangement like the FASB – with full-time members and staff along with adequate funding – became the goal of the organisations interested in improving state and local government accounting.

Also in the 1970s, many local governments and some state governments began contracting private-sector auditors – Certified Public Accountants (CPAs) – to perform financial audits in order to improve the credibility of their financial reports to the municipal bond markets. External audits usually evaluate financial presentations in terms of GAAP. However, NCGA standards were not recognised as GAAP by the AICPA, and the NCGA lacked the resources to substantially improve its work. Thus the search began in 1980 for an alternative standard-setting institutional structure.

The FASB wanted to preserve its status as the exclusive promulgator of GAAP and offered to set GAAP for governments. State and local governments were unwilling to submit to the authority of the FASB or a structure set up or dominated by the federal government. Unfortunately, due to their large number and diverse interests, state and local governments themselves were unable to create a standard-setting organisation with legitimacy, technical expertise and adequate financial support. Besides acceptance by the governments, such a body would need legitimacy from two other sources. The first was the AICPA, which as the professional association of auditors held the key to granting GAAP recognition. The second was the financial market as represented by the municipal bond rating agencies, which demanded financial statements audited by CPAs in accordance with GAAP.

After protracted negotiations, a Governmental Accounting Standards Board (GASB) was created in 1984 as a sister board to the FASB under the Financial Accounting Foundation, which was expanded by adding a number of trustees to represent the public sector. A broad-based Governmental Accounting Standards Advisory Council (GASAC) was also formed to represent not only the professional communities but also the political leadership, such as mayors, governors and state legislatures. To date, resource restrictions have limited the GASB to be essentially part-time with a full-time chairman and a full-time technical staff of a dozen professionals. The part-time members increased from four to six in number recently. After an interim period, the AICPA in 1986 granted the GASB standards the designation of GAAP. In the next section, we will examine how government GAAP have changed.

5.3. Policy reform

Until the mid-1970s, American state and local government accounting was dominated by budgetary practices. The budgeting system is organised in terms of funds, which are pools of financial resources to be used for specific purposes. Reflecting the separation between the operating budget and capital budget, the funds are similarly classified. The budget amounts were typically expressed in terms of cash and authorised obligations. In order to minimise conflicts with the laws that govern budgeting and financial management, and to meet the legal compliance objective, accounting principles required accounting and financial reports to respect legal provisions. So long as the reports are prepared for administrators and city council members, this approach was appropriate and probably sufficient. However, following the well-publicised municipal fiscal crises in the 1970s, external accountability received much more emphasis.

In response to calls for greater fiscal accountability, the NCGA in the 1970s adopted a number of measures. First, it declared that its nation-wide uniform standards would only cover governments' external financial reports, leaving the governments complete discretion to design special-purpose reports to meet legal requirements and management needs. Second, the multitudes of funds used in governments are classified into several generic fund types, which are then grouped as governmental fund types, proprietary (*i.e.* business-like) fund types and fiduciary fund types.[10] Third, proprietary funds were required to follow private-sector GAAP, and governmental funds would use the modified accrual basis and disclose comparisons with their budgets, if any, in year-end financial statements. Fourth, overview ("combined") financial statements, with each column representing one fund type, would qualify for "fair presentation" as required by GAAP. These statements and the detailed fund statements and other financial statistics would constitute the financial section of a government's Comprehensive Annual Financial Report (CAFR).[11]

When the GASB was established in 1984, it required the continued enforcement of existing NCGA standards in order to ensure continuity. In the next 15 years, the GASB adopted a total of 35 standards of varying breadth and depth on diverse topics. The most significant standards were Statement No. 11 that attempted to change the measurement method of governmental funds, and Statement No. 34, which substantially revised the structure and content of financial statements. These two statements are briefly described below.[12]

GASB Statement No. 11 was confined to dealing with the operating statement of the governmental funds, which report revenues and expenditures. The GASB decided that the flow of financial resources – instead of *current* financial resources – was the proper measurement focus for this financial statement, and an accrual basis – instead of the *modified* accrual basis – should be used. Instead of using cash receipts as a criterion for recognising revenue, the board was concerned with whether the underlying transaction had concurred and the government had demanded payment (in the case of taxes) or had a legally enforceable claim (in the case of fines, licenses and permits). Expenditures would be recognised to the extent of claims against the government's financial resources. Furthermore, expenditures were to be categorised as capital expenditures (*i.e.* those giving rise to capital assets) or operating expenditures. The board reasoned that this approach would enable users to judge whether current-year revenues were sufficient to pay for that year's services consistent with the criterion of inter-period equity. Unfortunately, after its impacts on financial statements were assessed, the implementation of Statement No. 11 was indefinitely postponed.

The demise of Statement No. 11 led to further research and deliberations. Finally in June 1999, the GASB released a definite new reporting model in Statement 34. The statement requires governments to include both *government-wide* and fund financial statements as their basic financial statements. A management discussion and analysis is also required to give an overview of the government's financial activities.

The government-wide financial statements resemble the business and non-profit financial statements required by the FASB. They consist of a statement of net assets (formerly the balance sheet or statement of financial position) and a statement of activities (formerly the operating statement). Governmental and business activities are distinguished, while fiduciary activities are excluded. The financial statements will adopt economic resources as their measurement focus and use the (full) accrual basis of accounting. This means that capital assets, including infrastructure assets, will be included and reported in terms of their historical costs. These assets are to be depreciated as well and depreciation expense will be reported in the statement of activities. Depreciation is exempted for infrastructure which is part of a network (*e.g.* a highway system), if certain requirements to ensure their maintenance are met.

Statement No. 34 also requires fund financial statements for governmental and proprietary funds. Major funds are to be presented individually, while the other funds are grouped together for reporting. The measurement methodology would remain the same: modified accrual for governmental funds and full accrual for proprietary funds. The differences between the government-wide and fund financial statements are reconciled and reported.

It is likely that the merit of the new reporting model will be debated for the foreseeable future, as Statement No. 34 is gradually implemented. Several issues are involved. First, the addition of another set of financial statements could increase information overload and compliance costs. Second, collecting information about infrastructure is costly, and the value of information about its historical costs and depreciation expense is in dispute. Third, the contribution of the new reports to greater accountability and better decision-making has not been empirically demonstrated. Fourth, accruals could lead to greater divergence between accounting and budgeting, raising the contentious issue of funding long-term liabilities. For at least these reasons, the implementation of GASB Statement No. 34 will present great challenges to state and local governments and the GASB.

5.4. Observations on American government accounting reform

In the American federal system, the national government cannot dictate the accounting policies of the states and the thousands of local governments. In the past 25 years, each level of government has pursued government accounting reform at its own speed and in its own way, with no discernible co-ordination. However, as Sections 3 and 4 demonstrate, their approaches have converged in several ways:

- Government accounting standards are set by a quasi-independent boards with extensive inputs from all interested parties.

- The form and content of financial reports, rather than accounting mechanisms, are the focus of the standard-setting boards concerned with the government's demonstration of public accountability.

- Accounting and financial reporting standards are no longer dominated by budget concepts and practices.

- The accrual basis, which captures the long-term consequences of current decisions, is the common preferred measurement method.

- The financial status of the whole government is given priority in external reporting in order to provide a context for detail disclosures.

- Accounting numbers are accompanied by public officials' discussion and analysis of the government's goals and activities to facilitate user comprehension.

6. Conclusion

Three features characterise the American experience in reforming government budgeting and accounting. First, the reform process has been a long series of trial-and-error experiments. Second, institutional fragmentation has created a mosaic of similar initiatives in various places at different times. Third, in view of the above two characteristics, only limited conceptual harmonisation between budgeting and accounting has been achieved.

6.1. Reform as experimentation

Budgeting and accounting reforms have been a long drawn-out process in both the federal government and in state/local governments. Contemporary federal budgeting reform can be traced to the early decades of the 20th century. Major institutional reforms took place in the federal government, once every few decades, in 1921 and subsequently in the 1930s and 1970s. In the last 50 years, almost every decade had a "new" budgeting system associated with it: program budgeting in the 1950s; planning programming budgeting in the 1960s; zero base budgeting in the 1970s; and mission budgeting in the 1980s. It took almost 60 years – between 1930 to 1990 – to satisfactorily resolve the issue of who should set federal accounting standards. Once this was settled, it took another 10 years to come up with a fairly complete set of standards.

After settling in a relatively stable largely Executive-driven budgeting system, budgeting reform in the state and local government sector has a pattern similar to the federal government. Institution building in government accounting standard setting was arduous. It took five years of on-and-off negotiations to set up the GASB, and another 15 years passed before the GASB came out with a new reporting model.

Each reform was itself an experimentation. Regardless of whether institutions, processes or policies were the object of change, often the changes were not based on empirical evidence of costs and benefits, but on hopes or anticipation for a better way. Sometimes revolutionary, sometimes evolutionary, the changes have continued for many decades with no end in sight. Thus it is best to view public budgeting and accounting as a continuous series of experiments.

6.2. Institutional fragmentation

The changes described in this paper were perhaps the response to the imbalances in the political system or conceptual framework. "When things are out of balance," a Chinese saying states, "they make sounds." The American system is particularly prone to internal imbalance because of its fragmentary character.[13] There are several types of fragmentation. The first type of fragmentation exists between the federal government and the states. Through the accountability provisions in federal grants and contracts, the federal government has influenced the budgeting and accounting practices of state and local governments. But these practices are implemented through the existing institutional structure of the states, which cannot be changed by the federal government. Tensions and conflicts are always a possibility because of the constitutional arrangement of federalism.

The second type of institutional fragmentation concerns the power sharing between the legislative and Executive branches. Legislatures have appropriation committees and staffs that check on executive budget proposals, second-guess economic assumptions and challenge spending priorities. While the process is messy, inefficient and ultimately political, that is an expected consequence of the separation of powers, and of checks and balances ordained in the Constitution of the United States and the constitutions of all states. Budgeting is generally a shared power between the legislature and the Executive in American Government, making it almost inevitably a political process. Financial management, including accounting and financial reporting, is generally regarded as an administrative function. But as we have seen, the American Congress has a tradition of attempting to micro-manage the government (at least from the administration's perspective).

The third type of institutional fragmentation is between the budgeting office and accounting office in the Executive branch of the same government. These two offices have different power bases and responsibilities. The budget director is usually an appointee answerable to the chief executive (the President, governor or mayor). A competent budget director is politically savvy, strategic and policy-oriented. The comptroller, or chief accountant, tends to be perceived as bureaucratic, operational and in charge of the details. In order to bring cohesion and effectiveness to the financial function, some governments have appointed chief financial officers; however the mandates of the CFOs vary. The budget director and comptroller have different rules to go by. The budget director is guided by the relevant laws and regulations of the government, or in the case of local governments, those of the states as well. Within the legal framework, there is room for innovations, such as a program budget to accompany the legally mandated line-item budget. The comptroller is obliged to keep the books in accordance to the applicable laws and regulations, he/she is also expected to follow national generally accepted accounting principles (GAAP) so that the financial reports can be given unqualified audit opinions. Inconsistencies and conflicts arise between law-based budgeting and GAAP.

While institutional fragmentation often produce inefficiency and conflicts, it also prevents any one of the contending forces from going to the extreme without encountering obstacles. The governance system in which American budgeting and accounting is embedded has the built-in capability to channel the conflicts into consensus most of the time, but not all the time.

6.3. Limited harmonisation

While theorists can go on debating the merits of centralisation and decentralisation, as a practical matter, it is reasonable to assume that the current institutional structure for American public budgeting and accounting will persist for the foreseeable future. However, in view of the interdependency between the two levels of government, and between budgeting and accounting, harmonisation should be a long-term objective. In terms of the 2x2 scheme at the beginning of this paper, there are two types of harmonisation: vertical harmonisation between the federal government and state/local governments, and harmonisation between budgeting accounting (see Table 2). Institutional fragmentation will however slow or perhaps even prevent the harmonisation of American budgeting and accounting concepts and standards.

Table 2. **Harmonisation possibilities**

	Budgeting	**Accounting**	**Horizontal harmonisation**
Federal government	(1)	(3)	(1) and (3)
State & local sector	(2)	(4)	(2) and (4)
Vertical harmonisation	(1) and (2)	(3) and (4)	(1) and (2) and (3) and (4)

Presently there exists relatively greater conceptual convergence in federal and state/local accounting and reporting standards. Both the FASAB and GASB have favoured whole-government financial reporting under the full accrual basis, even though the GASB still retains fund financial statements in the new reporting model. Both boards also require the reconciliation of actual and budgeted financial results. Both lack the authority to set budgeting standards, and accept budgeting rules as the basis for making the comparison. In the absence of a necessity to reconcile their differences in the detailed standards, the conceptual harmonisation make be undertaken only as an academic (*i.e.* academician's) exercise in order to arrive at a more general model American governmental accounting.

A modest degree of conceptual harmonisation between budgeting and accounting at both the federal and state/local level has been achieved. The federal government is using the accrual basis in budgeting for the cost of credit programs (*i.e.* direct loans and loan guarantees) and in funding employee pensions. Some state and local governments are using the modified accrual basis instead of the cash basis in budgeting expenditures. The merits of accrual budgeting continue to be debated. The budgetary and financial consequences of accrual budgeting remain to be systematically estimated. Little is known about the degree to which budget standards and decisions are susceptible to the influence of accounting concepts and standards. Furthermore there does not exist an institutional mechanism for debating the issues because there does not exist a budgeting standards board for American governments.

As in the case of accounting, there does not exist a legal basis for the federal and state/local government to do their budgets in the same way. However, state and local governments depend in varying degrees on federal financial assistance, and have to estimate the amount, timing and uncertainty of such aid – a task made more difficult by different starting dates of the fiscal year. There are some encouraging signs that harmonisation, or at least experiences are exchanged. The federal government has looked at the states' experiences with line-item veto and biennial budget, for example. Again this seems to be an issue for professional and academic inquiries rather than governmental co-operation.

In conclusion, only limited conceptual harmonisation can be expected from the system with so many separate institutions.

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NOTES

1. This section on federal budget reform draws from Chan (1999), Schick (2000), U.S. OMB (2000) and U.S. Senate Committee on the Budget (1993). Fisher (1975, 1991, 1993), Schick (1980a) and Trask (1996) discuss the historic contexts. Wildavsky and Caiden (1998) and Stein (1996) address related political and macro-economic issues.

2. This section on state and local budgeting draws on several types of sources. Hyde (1992), Gianakis and McCue (1999) and Gosling (1997) provide practices in general. Rubin (1998) describes historical evolution, and Briffault (1996) deals with balanced budget requirements. Schick (1980b) and Hammond and Knott (1980) analyses PPBS and ZBB. Peterson (1981, 1995) notes the limited abilities of cities to redistribute income. Osborne and Gaebler (1992) give examples of recent new management practices.

3. National Advisory Council on State and Local Budgeting (1998).

4. Bowsher (1995, 1987) discusses efforts by the GAO. Chan (1994) describes the background of the CFO Act; Jones (1993) and Jones and McCaffery (1992, 1993) critically analyse its implementation.

5. Bramlett (1991) and Bramlett and Rexford (1992) describe the formation of the FASAB. Steinberg (2000) provides a recent update.

6. Cuny (1995), Mautz (1991), and Rita and Eisenhart (1992) examine the nature of federal accounting standards, which are codified in FASAB (1997).

7. Philips, *et al* (1997) discuss the expanded role of federal financial managers.

8. Chan (2000) provides a comprehensive historic overview, while Remis (1981) examines the period from the 1930s to 1970s.

9. The transition from the NCGA to the GASB is discussed in Greathouse (1985), Chan (1985), Antonio (1985).

10. The governmental fund types consists of the general fund, special revenue funds, capital project funds and debt service funds. The proprietary fund

types are made up of enterprise funds and internal service funds. The fiduciary fund types encompass trust funds and agency funds.

11. The nature of government GAAP is analysed in Johnson and Langsam (1991) for state and local government, and in Mautz (1991) for the federal government.

12. GASB Statement No. 11 (GASB, 1990) is critically analysed in Chan (1998). GASB Statement No. 34 (GASB, 1999) is described in Chan (2000b, 2000c).

13. This paper focuses on the professions of budgeting and accounting. Actually, others are involved as well. Most American governments have a treasurer, an auditor, some have an inspector general, and all have a legal department. Generally, the treasurer manages cash and investments. While the federal governments handle its financial transactions through the Federal Reserve Banks, state and local governments transact through commercial banks. Government auditors are usually appointed by the legislature, although some are elected officials. They may be authorised by law to audit the government or private-sector auditors may be engaged to perform external audits. Inspector generals, as the government's chief investigator, look into allegations of fraud, abuse and other illegal acts. The law departments make sure that all proposed transactions and activities, such as procurement contracts and grant applications, are in compliance with applicable laws and regulations. Chan and Miranda (1998) discuss the principles for designing a sound financial governance structure.

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN GERMANY
BY
KLAUS LÜDER[*]

1. The national context

1.1. State structure[1]

Germany is a federal state and a parliamentary democracy with three levels of government: the federal, the state and the local level. Its type of federalism is called "co-operative" due to the constitutionally based system of close intergovernmental relations. This refers to legislation, execution of laws, as well as to revenue-sharing.

The German legal system is unified in all areas of law. This has been achieved by means of the federal government's concurrent legislative power and by its right to enact framework legislation. On matters of the so-called concurrent legislation of the federation and the *Länder* in presently 29 areas as specified in Articles 74 and 74a Basic Law: "The federation has the right to legislate ... if and to the extent that creation of equal living conditions throughout the country or maintenance of legal and economic unity makes federal legislation necessary in the national interest" (Art. 72 Para. 2 Basic Law). On the same conditions, Article 75 Basic Law grants "the federation the right to enact framework legislation for the legislation of the *Länder*" on seven more areas.

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"The *Länder* (state governments) shall execute federal statutes as matters of their own concern insofar as the Basic Law does not otherwise provide or permit" (Art. 83 Basic Law). Exceptions of this principle are enumerated in Articles 87-87f Basic Law. In all other cases, enforcement of federal legislation is a responsibility of the *Länder*. Municipalities, although autonomous entities with constitutionally guaranteed authority to decide on local matters, also serve as agents of the federal and the state governments in enforcing their respective laws at the local level.

As a consequence of the interlinked task-sharing system of German governments, the system of distribution of financial resources among the levels of government is similarly interlinked. This system consisting of joint and separate taxes for federal, state and local governments with unified tax rates, except for local taxes, and fiscal equalisation (tax compensation) between jurisdictions of the same level of government as well as between the different levels of government is aimed to provide the jurisdictions with the financial resources that are necessary for the execution of their respective tasks and "to ensure equal living conditions in the federal territory" (Art. 106, Para. 3 Basic Law).

The German public sector consists of one federal government, 16 state governments and about 14 000 municipal governments. The Executive branch of each of them can be divided into two sectors: the "core" government sector and the "peripheral" government sector. The *core* sector at each level of government is composed of departments, agencies, and other non-commercial organisational units. The core sectors together with the quasi-corporations (*e.g.* utilities) form the respective legal entities of "federal government", "state government" and "local government". The *peripheral* sector consists of quasi-corporations, statutory corporations (*e.g.* universities, social insurance corporations, banks) and government-owned companies established under company law (*e.g.* housing companies, public transport companies, post and telecommunications companies).

The number of public sector personnel is nearly five million, 38% of whom are civil servants and 62% government employees.[2] The high rate of professional qualification of German senior civil servants is mainly determined by the significance and the complexity of law and by the density of legal regulations. The degree of legislation in German life requires a great number of law experts in government, who – at least in the past –in turn generated further complexity and density in legal regulations. Geert Hofstede (1997) in his study on cultural values of nations ranked Germany "medium" with regard to individualism and "medium to high" with regard to uncertainty avoidance. This corresponds to the constitutional provision according to which "the federal

Republic of Germany shall be a democratic and social federal state" (Art. 20, Basic Law) and is confirmed by the density of the "social net"; the uniformity of law; and the tax and fiscal equalisation systems. Germany is not only a "Rechtsstaat" – a state under the rule of law, in the continental European tradition, but also a "Welfare State".

1.2. Traditional budgeting and accounting

German governmental budgeting and accounting at all three levels of government (federal, state and local) is regulated by law and not by any government external standard-setting body (such bodies, even in the form of advisory bodies to the government on matters of public sector accounting, do not exist in Germany).

The legal framework of governmental accounting is a hierarchy comprising:

- Chapter X (Finance) of the Basic Law;
- the Budgetary Principles Act of 1969 (*Haushaltsgrundsaetzegesetz*), which is a piece of "framework legislation" enacted according to Article 109, Para. 3 of the Basic Law: "Through federal legislation ... principles applicable to both the federation and the *Länder* may be established governing budgetary law, budget management and multi-year financial planning";
- the Federal and State Budgetary Acts of 1969-1971 (*Bundeshaushaltsordnung und Landeshaushaltsordnungen*);
- the Municipal Budgetary Acts of 1972-1974 (*Gemeindehaushaltsverordnungen*); and
- federal and state regulations specifying the stipulations of the Budgetary Acts (*Verwaltungsvorschriften zur Bundeshaushaltsordnung und den Landeshaushaltsordnungen*).

This legislation that established the legal basis of the present public sector financial management system was the result of the first budgetary and accounting reform following the end of World War II. In the wake of Keynesian economics and a strong belief in the effectiveness of fiscal policy to ensure the nation's economic development, adapting the budgetary system to the needs of macro-economic fiscal control was the overriding objective of the legislation.

As Section 2 of the Budgetary Principles Act states: “The budget shall form the basis for financial and budgetary administration. When it is being prepared and executed, due account shall be taken of the requirements of general economic equilibrium”. Unlike other Western countries at that time, Germany did not include any program budgeting approach in its public sector financial management legislation.

The main objective of the 1969 budgetary reform was to increase the flexibility of budget execution and this was achieved by a range of measures including: abandoning the extraordinary budget (budget of debt-financed capital expenditures); extending the possibilities of transferring funds between budget items and carrying forward unspent appropriations; granting commitment authorisations; and (not least) by enhancing the government’s discretion regarding deficit spending. Multi-year financial planning was subsequently introduced, covering a three-year period beyond the time horizon of the current budget.

The accounts of the core governments are kept on a modified cash basis. The budget of German jurisdictions is an annual or biennial line-item budget containing payment authorisations, commitment authorisations (authorisations to incur obligations that lead to payments in future fiscal years), borrowing authorisations and estimated revenues. It must be formally balanced and Article 115 Basic Law requires that “revenue from borrowing shall not exceed the total expenditure for investment provided for in the budget estimates; exceptions shall be permissible only to avert a disturbance of macro-economic equilibrium”. Since in budgetary practice borrowing is interpreted as net borrowing and investment as gross investment including replacement investments and for other reasons, this constitutional provision has not proved to be effective in restricting the growth of public debt. All revenues and expenditures are recorded twice, when due and when collected or paid, respectively. The amount of revenues and expenditures due but not received and collected at the end of the fiscal year (which is the calendar year) are shown in the accounts as receivables and payables. The bookkeeping method used is single entry called “cameralistics”.[3] Article 114 Basic Law requires the Minister of Finance to “submit to the *Bundestag* and the *Bundesrat* annual accounts for the preceding financial year covering all revenue and expenditure as well as assets and debts”. A main component of the annual accounts is the line-by-line statement of actual revenues and expenditures whereas the “statement” of assets and liabilities is only an incomplete annex containing just monetary assets and capital market debt. Thus, traditional governmental budgeting and accounting in Germany is input-oriented, cash-based, compliance-oriented and exclusively aimed to meet the budgetary control needs of the legislature.

With the entities of the peripheral sector of government the situation is different: most of them use commercial accounting which means it is on an accrual basis, in technical terms it is double-entry bookkeeping and a set of financial statements consisting of a complete balance sheet and a profit-and-loss statement is produced. Consequently, the budget of those entities encompasses a budgeted profit-and-loss statement as well as a budgeted cash flow statement. This means that budgeting is also accrual-based.

1.3. Stimuli for budgeting and accounting reform

Traditional government accounting in Germany, as in most other Western countries, is incomplete and lacks transparency, It does not provide any information on the efficiency of administrative action nor does it provide incentives for cost conscious behaviour of civil servants. In addition, it is not appropriate for rendering an account on a government's financial management to the general public.

These long-time latent weaknesses of the traditional budgeting and accounting system became obvious in the early 1990s for the following reasons:

First, due to remarkable continuous budget deficits in the 1970s and 1980s and as a consequence of German unification, public debt and interest expenditures reached a critical level by the mid-1990s. The "debt-to-GDP" ratio of 60% met the upper limit set by the Treaty of Maastricht for the member states of the Economic and Monetary Union (EMU). This financial situation, which meant an unacceptable shift of financial burden to future generations, became a political issue and forced governments, among others, to think about measures aimed at increasing public sector efficiency. For this purpose, the accounting system has to produce information on the efficiency of government action (*i.e.* on outputs and costs) and both budgeting and accounting have to provide incentives for (more) efficient behaviour of legislators and bureaucrats. The availability of an appropriate budgeting and accounting system is crucial for achieving improvements in public sector efficiency.

Second, the idea of a New Public Management (NPM) developed and implemented in New Zealand in the 1980s also gained ground in Germany's public sector. The concepts of privatisation, corporatisation, and devolved and business-like public management seemed particularly appropriate to achieve a leaner administration and the badly needed improvements in efficiency. But such public management reform was again not conceivable without reform of the budgeting and accounting system which replaced the input-oriented and cash-based traditional system with an output-oriented and accrual-based new system.

Third, over the last decades the peripheral sector of many German governments (particularly larger local governments) has constantly grown through the creation of semi-autonomous government entities and government corporations at the expense of the core sector. The municipal workforce employed in the peripheral sector had grown to 50% of the total municipal workforce. The creation of legally independent but government-owned organisations became even more of an issue in the 1990s as an NPM modernisation strategy and as an attempt of governments to shift debt and deficits to those entities that do not belong to the public sector in the national accounts. This drifting apart of the two sectors of government and the "crowding-out" of tasks from the core sector into the peripheral sector has been accompanied by often unintended autonomy of the corporatised entities caused by insufficient and inappropriate control. In respect of accounting, the core sector and the peripheral sector of government represent "two different worlds". The core sector is characterised by traditional line-item budgeting, cash-based accounting and single-entry bookkeeping. In the peripheral sector, on the other hand, budgets are more global (*i.e.* consisting of a few lines; in the extreme, under net-budgeting there is just one appropriation per entity), accounting is fairly close to commercial (accrual) accounting and the double-entry bookkeeping technique is used. As a consequence, it is impossible to blend the accounts of the two sectors in a meaningful way and thus, whole-of-government financial statements which provide information on a government's overall financial position and changes thereof cannot be prepared. This issue of deriving useful summary financial information from the accounts has become more severe with the increasing financial significance of the peripheral sector. The obvious conclusion with regard to accounting reform is a shift of the accounting system of the core sector of government to an accrual basis and the measurement focus of the statement of assets and liabilities from net monetary debt to economic resources. Such a change would also meet the request for more complete and transparent financial reporting of governments.

2. Reform endeavours in Germany

2.1. Legal framework

In Germany, the federal Parliament sets rules for the federal government and, on matters of concurrent and framework legislation, also for the *Länder*. The *Länder* participate in the legislative process by the *Bundesrat*. The Ministry of Finance of the federal government and of each *Land* is in charge of its budgeting and accounting. The affairs of municipalities in each Land, including budgeting and accounting matters, fall under the jurisdiction of the Ministry of the Interior of the *Land*. The Standing Conferences of the *Länder's* Prime Ministers, Interior Ministers, etc. serve as a co-ordinating mechanisms among the *Länder* to promote information sharing and uniformity.

Government budgeting and accounting reform in Germany is therefore not conceivable without prior legal amendments. A first step in this direction was the amendment of the Municipal Acts and the Municipal Budgetary Acts in the 1990s by "experimentation clauses". This amendment permits local governments to apply budgeting and accounting approaches other than the ones provided for by legislation for a limited period of time. In addition, the Standing Conference of the *Länder's* Interior Ministers has set up a sub-committee "on municipal budget law" charged with specifying the legal provisions for an output- and accrual-based local government budgeting and accounting system to be included in the Municipal Budgetary Acts. As of today, the sub-committee has passed a document containing the key principles and elements of such a system. This document has received approval of the Conference and the whole amendment is expected to become effective in the *Länder* from 2003 onward. It will presumably be the decision of the individual *Land* to make the new output- and accrual-based system an obligatory requirement or just an option for the municipalities.

As for the federal and state governments, the Budgetary Principles Act was amended in 1998. The main objective of this amendment was to strengthen cost-consciousness and thus improve efficiency in preparing and executing the budget. This is expected to be achieved by means of greater budget flexibility (more discretion for government entities to transfer funds between budget items and to carry-over unspent funds) and introducing cost accounting in government "where suitable". Moreover, the *Bundesrat* succeeded in adding two new sections to the act. According to Section 6a, global budgeting of governmental units on a cash basis is allowed on the condition that:

- appropriate information and control devices are available to ensure keeping the actual net expenditures within the budget limits;

- outputs are specified and included in the budget or an other legal document;

- appropriations are also shown in the traditional way, *i.e.* by object of expenditure.

In addition, Section 33a now permits the government to shift its financial accounting system to an accrual basis but again without abandoning the former cash-based system. Thus, the budget and accounting reform approach underlying the latest amendments of the Budgetary Principles Act can be called an “additive approach”. That is, it opens up new options only on the condition of meeting the old requirements.

Since the Budgetary Principles Act contains framework legislation for the federal government and the *Länder* governments, it has to be transformed into federal and state law. This has been done over the last two years, but interestingly not all jurisdictions included the new options of the Budgetary Principles Act in their respective Budgetary Acts. The federal government, for instance, neither adopted Section 6a nor Section 33a. Its stance on Section 33a of the Budgetary Principles Act is that accrual financial accounting is not imperative for governmental financial management.

2.2. Reform projects in local, state and federal governments

Given the stimuli mentioned before, budgeting and accounting reform commenced at the *local government* level after 1993. The driving forces were an “epistemic community” (Laughlin/Pallot 1998, p. 385) mainly consisting of scholars, a non-profit institution called “Local Government Centre for Management Studies” (KGSt) linked to the Federation of German Cities, and consulting firms. This group requested the introduction of output budgeting, cost accounting and accrual financial accounting in municipalities and in the public sector at large. They tried to convince relevant participants in the political process that such a reform is necessary and timely. These reform ideas were then accepted by a great number of mayors and municipal chief financial officers (CFOs), who initiated pilot projects under the experimentation clauses of the Municipal Budgetary Acts with the focus on output budgeting and cost accounting. At this stage of the reform, the Ministry of the Interior of Baden-Württemberg was the only one to assume an active role in the process by launching a *Land*-wide pilot project in the City of Wiesloch. In all other *Länder*, uncoordinated, individual approaches prevailed and the Ministries of the Interior just watched the different developments from the outside.

The Wiesloch project commenced on 1 October 1994 and was by and large completed by 30 June 1997. In addition to the city, the other partners in the project were the Ministry of the Interior, the German Postgraduate School of Administrative Sciences in Speyer, the Regional Computer Center in Heidelberg, and the software vendor SAP. The aim was:

- to develop the conceptual basis for accrual accounting in local government, including a generally applicable chart of accounts;

- to adapt business accounting software to the needs of the new municipal accounting system;

- to run a half-year test of the new accounting system in parallel to the old one to demonstrate its capacity and detect problems;

- to prepare financial statements for the core government and consolidate them with the financial statements of the peripheral entities at the end of the testing period;

- to develop a conceptual basis for accrual budgeting in local government; and

- to recommend the necessary legal amendments for routine operation of the system.

Later on, the accrual budget was supplemented by an output structure and performance indicators.

Since the pilot project succeeded in the opinion of the institutions involved, the City of Wiesloch continued with the new budgeting and accounting system after the end of the project. The city operated the new system initially in parallel to the traditional cameralistic system. It later received permission from the Ministry of the Interior to abandon the cameralistic system at the end of 1998. Thus, Wiesloch is the only German city so far to exclusively use an output- and accrual-based budgeting and accounting system since 1 January 1999.

Triggered by the deliberations of the Sub-committee on Municipal Budget Law and by the growing conviction of ministerial officials that a fundamental change of local government budgeting and accounting will be unavoidable, other *Länder* have also started pilot projects. These projects aiming to secure a *Land's* influence on the new municipal budget law as well as to re-standardise the diverging reform approaches of the individual municipalities. They were set up in Hesse in 1998, in Northrhine-Westfalia in 1999 and in Lower Saxony in 2000. These pilot projects share similar objectives and conceptual bases. Their main objective is the test of a new budgeting and accounting system comprising of the following elements:

- output- and accrual-based budget;

- accrual-based financial accounting and reporting; and

- management (cost and performance) accounting.

The conceptual basis is by and large the same as with the Wiesloch project. The differences are in the number and size of municipalities involved, in the consultants involved (academic experts *vs*. commercial consultants) and in the software used. Although all proponents of new pilot projects indicate their intention is not "to reinvent the wheel", that is what actually happens due to political competition between the *Länder* and by competition between the consultants.

As to the *Länder* themselves, the key players in budgeting and accounting reform are the Ministers of Finance and their permanent secretaries (*i.e.* most senior civil servants). The vast majority of them is less reform-minded than the average municipal CFO and even their colleagues in the Interior Ministries. They prefer a reform approach that is called "extended cameralistics". This means that the existing cash-based budget is enhanced by output information, and the cash-based financial accounting is supplemented with cost and performance information for either all or just selected core government entities. An exception is the government of Hesse, which decided in 1998 to convert its traditional input- and cash-based budgeting and accounting system to an output- and accrual-based system for all governmental entities and the whole-of-government over a ten-year period. Even though the parliamentary majority and thus the government changed in 1999, the reform approach and its time horizon remained unchanged. However, responsibility for the reform project has been shifted from the Ministry of Finance to the Prime Minister's Office, which seemingly meant a loss of political momentum.

But, apart from everything else, it must be kept in mind that there still is a legal obstacle for more fundamental reforms such as the Hessian case. The Budgetary Principles Act as of today does not allow *Länder* governments to abandon traditional cameralistic budgeting and accounting.

Irrespective of the type of reform *Länder* governments are pursuing, they are all in the phase of running pilot projects of different kinds with often poor conceptual preparation, insufficient co-ordination, inadequate systematic evaluation and struggling with software problems. It is therefore very hard to predict what the end stage of the *Länder's* reform endeavours will be and which kind of budgeting and accounting system they eventually will have implemented.

At the *federal level*, again the Minister of Finance and his permanent secretary are the key people in budgeting and accounting reform. So far, the stance of the present minister, a Social Democrat, and of the former minister, a Christian Socialist, has been the same. That is, neither output-oriented and accrual-based budgeting, nor accrual financial accounting, are necessary and beneficial in federal government. They also believe that increased budget flexibility and the introduction of cost-accounting in appropriate governmental entities are sufficient to meet the needs of good governmental financial management. The political backup for budgeting and accounting reform in the Ministry of Finance seems rather poor; it may even be considered as *"quantité négligeable"*.

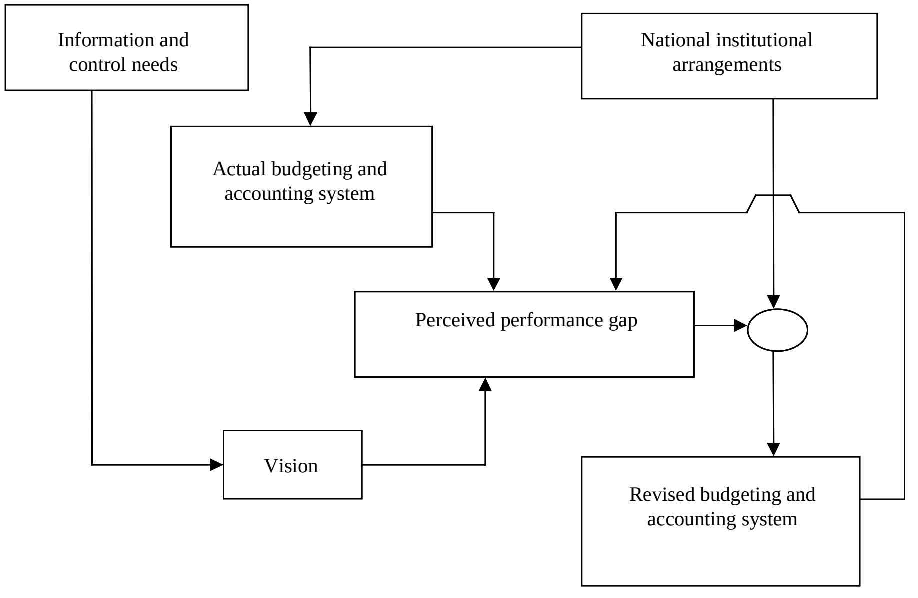
In December 1996, the Federal Ministry of Finance commissioned a consulting firm to develop a "Standardised Cost and Performance Accounting System" for the federal government. The system was presented in July 1997 and it now serves as a framework for setting up cost accounting systems for governmental entities, as well as "textbook" for the education of government officials in cost accounting. The present situation in the federal government can be described as a patchwork of cost accounting systems of varying degrees of sophistication, at different stages of development with different significance as a management tool. These systems are not linked to the budget and the budget process. However, it is hardly conceivable that this is the end stage of budgeting and accounting reform in federal government.

3. The international context

In many Western countries, the stimuli for budgeting and accounting reform discussed in Section 1 can be observed. The traditional input-oriented budgeting and cash-based accounting system of these countries no longer meets the requirements of public sector management and accountability. It doesn't provide any or only insufficient information on public sector performance and efficiency. It does not provide any incentive for efficient production of public sector services. Furthermore, the information output is incomplete and lacks transparency. This perceived performance gap of traditional government financial management then usually gives rise to reform endeavours when severe fiscal strain occurs. It can also lead to a broader public sector reform or even of a fundamental change of a government's information technology systems.

The existence of stimuli for budgeting and accounting reform together with a dominant reform doctrine ("public sector accounting should be similar to commercial accounting") might lead to the presumption that budgeting and accounting in all "reform countries" is going to converge to a uniform new public financial management and thus international harmonisation of government budgeting and accounting is achieved as a side effect. But in fact, reality looks different, because of national differences in the size of the perceived performance gap and in the national institutional arrangements such as the legal systems and the politico-administrative systems. The perceived performance gap again is determined by experiences with the actual budgeting and accounting system as well as by the "vision" of a new system and its expected effectiveness (Figure 1).

Figure1. **Reform Process Model (basic version)**



To meet the information and control needs of an efficiency-oriented government as well as the information and accountability requirements of legislators and the public at large, the vision of a performance (output) and resource (accrual-based) budgeting and accounting system seems most appropriate. The components of such a system are budgets containing outputs (goods, services) linked to cash and non-cash financial resources appropriated for output production, accrual-based financial accounts, and management accounts providing information on actual outputs and costs of government services. Nevertheless, governments in different countries do not necessarily strive for this ideal version of a new public financial management system, but its more or less close approximations. Moreover, the national reform projects also differ with regard to implementation strategy and implementation pace. These are not least influenced by national cultural features such as the attitude to risk avoidance. A low degree of risk avoidance results in more fundamental changes, leading to a substitution of a "new" system for an "old" one and in fast implementation pace. A high degree of risk avoidance, on the other hand, usually means cautious, gradual and slow change, in order to secure reversibility, through amendment instead of substitution whenever possible.

A summary overview of the state of financial management reform in selected Western countries is provided by the survey studies of the OECD Public Management Service (see Figure 2).

Figure 2. **Accrual accounting and budgeting in the public sector**

	Accrual accounting for individual agencies & departments	**Consolidated whole-of-government accrual accounting**	**Accrual budgeting**
Australia	Since 1995	Since 1997	From fiscal year 1999-2000
Canada	From fiscal year 2001-02	From fiscal year 2001-02	No
Finland	Since 1998	Since 1998	No
Germany	Permitted since 1998	No	No
Iceland	Since 1992	Since 1992	Since 1998
Ireland	Pilot launched in 1995	No	No
Netherlands	Pilots launched in 1994	No	No
New Zealand	Since fiscal year 1991-92	Since fiscal year 1991-92	Since fiscal year 1994-95
Sweden	Since 1994	Since 1994	No
United Kingdom	Launched in 1993; all by fiscal year 1999-2000	Planned	From fiscal year 2001-02
United States	Since fiscal year 1997-98	Since fiscal year 1997-98	No

Source: OECD, PUMA, 1999a, p.4.

Another OECD PUMA survey (OECD, PUMA 1999b, p. 4) shows that performance information is contained in the budgets of 21 out of the 28 countries interviewed, including all of the countries of Figure 2. However, neither the kind nor quality of performance information can be gathered from the survey. It is also not clear whether performance targets are established for all or just selected outputs, and whether these are binding for the Executive or not. Of the 11 countries included in Figure 2, only New Zealand and Iceland have used accrual-based budgets for a longer time period, whereas Australia introduced them only recently, and the UK is planning to shortly shift its budget to an accruals base. The input of the budgets of the remaining seven countries is still on the cash basis.

In 1999, a comprehensive accrual-based financial accounting system for the departments and the whole-of-government at the national level has been in place in Australia, Finland, Iceland, New Zealand, Sweden and the United States. The fact that Iceland has introduced accrual governmental accounting at about the same time as New Zealand has been widely neglected.

According to an OECD PUMA publication on "Budgeting in Canada", the national government of Canada has adopted the Financial Information Strategy (FIS). Under this strategy, "full accrual accounting, including the capitalisation of fixed assets" will be introduced, and "all departments are expected to be fully compliant with FIS by 1 April 2000" (OECD, PUMA 1999c, p.35). The U.K. also belongs to the group of countries using accrual accounting in government, although the whole-of-government financial statements are still lacking in that country. The remaining countries (Germany, Ireland, the Netherlands) are still experimenting with new budgeting and accounting concepts.

In summary, the following conclusions can be drawn from the PUMA survey studies:

- In Western industrialised countries, there has been a tendency to shift the government accounting system from cash to accrual.

- Accrual budgeting does not necessarily follow the change from cash to accrual accounting.

- Furthermore, there is an effort to enhance budgets by including performance (output) information.

- Germany is the slowest and most cautious reformer among the countries listed in Figure 2.

A closer look at the changes of the accounting systems reveals that there are three basically different reform approaches: *i)* the introduction of an accrual-based accounting system in addition to the cash-based (budgetary) accounting system; *ii)* the introduction of an accrual-based accounting systems at the department/agency level leaving the whole-of-government accounting system unchanged (*i.e.* cash-based); and *iii)* the complete substitution of accrual accounting for cash accounting in all government units and the whole-of-government. National variants in each of these basic approaches can be observed. So the common transnational movement of shifting government accounting to accrual does not result in quasi-automatic harmonisation of governmental accounting. On the contrary, the range of national accrual accounting practices may even become wider than the one of cash accounting practices. Thus, endeavours for international standardisation of public sector accounting as initiated by the Public Sector Committee of the International Federation of Accountants are necessary and timely.

4. Conclusions and perspectives

Changes in public sector financial management systems in Germany are, by and large, a direct consequence of attempts to reform the public sector through privatisation, corporatisation, decentralisation, devolved management, competition and the output performance orientation. Changes in public sector financial management in Germany have been relatively slow and careful in order to avoid uncertainty. They were first pursued in local government, and later by *Länder* and federal governments. They have focused on budgeting and managerial accounting, and are driven by techniques.

The change process at all levels of government is characteried by a “step-by-step” approach. It involved setting up committees (such as the “Lean State” Committee at the federal government level), and the undertaking of pilot projects. This avoided the need to amend the legal basis of financial management in the early phase of the reform process. The legal enabling of pilot projects resulted in a great number of those projects with often poor conceptual bases, unclear objectives, insufficient co-ordination and systematic evaluation of the outcomes. The expected outcomes were to shape the future financial management system and to enact the necessary technical and institutional changes. The pilot project approach is certainly beneficial in the early phase of public sector financial management reform as it enables jurisdictions to test new ideas, particularly in countries with very stringent and detailed legal provisions for public sector financial management. The danger, however, is that the reform process may never get beyond piloting. Thus, sufficient conceptual guidance, clear objectives and a limited time frame seem crucial for pilot projects to be a useful element in the reform process.

Mainly due to different degrees of fiscal stress, financial management reform commenced in local government. This process was either “state guided” (as, for example, in Baden-Württemberg), or “chaotic” in the sense that the *Länder* government has not given sufficient direction to the many and varied reform endeavours of municipal governments (as, originally, in all the other *Länder*). The decision to amend municipal budgetary law, in the meantime, has caused all the *Länder* have taken on a more active role in the reform process. Local government financial management reform can therefore be expected to be irreversible. *Länder* and federal governments are slowly following local governments in attempting to change their financial management systems. But, a majority of them still prefer an additive reform approach. They intend to supplement the existing system by new elements, such as output budgeting and cost and performance accounting. A complete substitution of an accrual budgeting and accounting system for the traditional cameralistic system is still inconceivable for most of these governments and their political leaders.

Most financial management reform endeavours have centred on developing output structures for budget purposes and on cost accounting. Even though governments have sought to make some links between their cost accounting system and their existing single-entry cameralistic financial accounting system, the approach remains flawed and again reflects the prevailing attitude of uncertainty avoidance. But, as they gain experience in running these systems, more and more jurisdictions reached the conclusion that they should strive for the introduction of a comprehensive and integrated financial management system consisting of output- and accrual-based budgeting, accrual-based financial accounting and cost and performance accounting. This is for technical reasons as well as for achieving the objective of improved efficiency and transparency. In terms of a comprehensive and integrated public sector financial management system, the components "accrual financial accounting", "cost accounting" and "accrual budgeting" are available. Existing problems relate mainly to the output structure of the budget, to the definition of suitable performance indicators, and to measuring non-financial performance.

All the components of a comprehensive and integrated financial management system usually cannot be implemented at the same time. If the components are introduced sequentially, German experience with financial management reform suggests to start with financial accounting followed by cost accounting, accrual budgeting, output budgeting and performance accounting.

Although financial management reform can be seen as a key element of public sector reform in Germany, it is part of it and it does not stand alone. Nevertheless, the emphasis so far has primarily been on the more technical issues of budgeting and accounting and less on changes in organisational, personnel structures and processes. Given the present national and international context, and the increasing pace of public sector financial management reform in the recent past, the implementation of a new financial management system comprising the components mentioned above, does seems likely. But, whether this will be accompanied or at least followed by a public sector reform according to the New Public Management approach still remains to be seen.

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NOTES

1. A brief explanation of the German governmental and legal system follows: (a) the federal Republic of Germany is a federation of states called *Länder*; each state is called a *Land*. The governmental structure of the *Länder*, consisting of the legislative and Executive branches, parallels that of the federation; (b) the Lower House of the German Federal Parliament, elected by the people, is called the *Bundestag*; the Upper House of Parliament, called the *Bundesrat*, consists of representatives of *Land* governments; (c) the Basic Law is Germany's constitution. Its chapter on finance (Chapter X) provides for taxation, fiscal equalisation among the *Länder*, budgeting, financial reporting, auditing and borrowing. Its strong legal orientation makes Germany a *Rechtastaat*, or a state under the rule of law; (d) when the Federal Parliament passes a *concurrent legislation*, the law applies nation-wide; (e) when the Federal Parliament passes a *framework* legislation, the *Länder* have to enact measures consistent with the federal legislation.

2. Civil servants (*Beamte*) are a class of government employees whose legal status and remuneration, including pension arrangements, are provided by administrative law. They are not allowed to strike. Private law contracts specify the relationship between the government and its other employees, who are not civil servants. The remuneration of these employees is determined through collective bargaining between their labour unions and the government.

3. Cameralistics, or cameral accounting, is a special version of cash accounting in the public sector invented in Austria some 250 years ago. It is primarily used in German-speaking countries and some others that belong to the "German public sector accounting sphere" such as Belgium, the Netherlands, Norway and Finland.

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN SWITZERLAND
BY

KUNO SCHEDLER*

1. Introduction

Public sector financial management in Switzerland has historically been concerned with the management of inputs needed to produce government services. This is still the case for the majority of government agencies. However, there seems to be a growing general understanding that the focus of public management control systems should be widened to include outputs and outcomes, and that they should be combined with decentralised organisational structures and management by delegation. Buschor (1993, p. 241) has argued that these new tendencies will increase the demand for new instruments and regulatory frameworks, including: *i)* cost and performance accounting; *ii)* value-for-money management via performance measures and indicators; *iii)* performance agreements for public services combined with a high degree of freedom in shaping organisational and personnel management policies and a range of "marketable" performance components; *iv)* comprehensive result-orientation by means of benchmarking; and *v)* financial and non-financial incentive sanction mechanisms.

The latest reform debate about public sector accounting in Switzerland is a reaction to general public sector management reforms. This country started with experiments with forms of "New Public Management" in some cantons (similar to provinces or states in countries with a federal system) and local communities in the 1990s. These followed examples provided by reforms in the Netherlands ("the Tilburg Model") and New Zealand. However, major financial management reforms took place long before the current movement of "managerialism" and "marketisation" reached Switzerland. Forced by reliance on non-professional parliamentarians and part-time civil servants in smaller

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communities, Swiss government agencies have always been closer to the private sector in character than their counterparts in neighbouring countries.

This paper explores the current concepts of public sector accounting in Switzerland, as well as developments during the last 10 years. It is based on an international study undertaken in the late 1990s by a group of researchers (see Schedler 1998, pp. 276-303), and it has been updated to reflect developments up to the end of 2000.

2. Relevant context and political structures

Switzerland lies at the heart of Europe, surrounded by member nations of the European Union. It shares borders with five countries and has three large linguistic areas. The Swiss Confederation was founded in 1291 and has 26 cantons. The Swiss Federal Government (called the Federal Council or *Bundesrat*) is a collegial body of seven ministers. Switzerland neither has a President nor a Prime Minister. The seven Federal Councillors, who have equal rights, constitute one single decision-making body. A notable feature of Swiss Government at all three levels (Confederation, cantons and communities) is the country's system of direct democracy. Democratic awareness has deep roots in the Swiss political culture. Any attempts at changing the people's rights to intervene by voting in favour of more efficient processes would likely provoke resistance among the people and their representatives. Some analysts have regarded this feature as a significant obstacle to the introduction of reforms in Switzerland's politico-administrative system (Delley, 1995; Knoepfel, 1995).

Relationships between the Swiss Confederation and the cantons reflect a pronounced financial federalism. The cantons are largely independent in financial and fiscal matters. They are free to fix the type and rate of taxation levies and to select instruments of financial management, including accounting and budgeting models. According to the principle of subsidiarity, the higher (federal) level of government is only allowed to become active if the lower (cantonal) level is incapable of fulfilling a specific function. In terms of financial management, there is virtually no possibility of the Swiss federal Government imposing any specific instrument on the cantons. Attempts at harmonisation will invariably depend on the canton's readiness to co-operate. For example, in 1998, the national Minister of Finance complained to the Conference of Cantonal Ministers of Finance that it was increasingly difficult to uphold a minimal standard of harmonised financial information for statistical purpose. He then invited the conference to increase their efforts of harmonisation among the cantons. Until today, only few actual results came out of this action. There are, however, strong interests of the cantons to make their data comparable to each other, so that since 1999 several recommendations have been published to regain the degree of harmonisation of financial statements.

3. Financial management in federal government

3.1. Phases of development

Over the last 30 years, accounting models in Swiss governments can generally be seen to have passed through three main (but somewhat overlapping) phases:

- a traditional phase (prior to 1978) characterised by a cash-based accounting model;

- a contemporary phase (1978-1993) characterised by the introduction of full accrual accounting at the cantonal level and the creation of a consolidated accrual account at the federal level (additional to the existing itemised cash account) which led to a partial harmonisation with the cantonal accounting model;

- a managerial phase (1994-today) characterised by massive reform efforts to focus on cash and financial planning primarily through "product service" budgets to provide control over output and outcome.

As this paper concentrates on the last 10 years, the traditional phase will not be dealt with here. In addition, the primary focus will be the federal level, although developments in the cantons have had a certain impact on the federation's accounting system

The Contemporary Phase. In the late 1970s, an agreement was reached at cantonal and communal levels to introduce a system of full accrual accounting. Since then, cantons have been recommended to implement the model, but they have the power to make the final decision (see also Mäder/Schedler 1994, pp. 345 ff.). The Confederation designed a new accounting model in the late 1980's. Until then, the federal accounting model had consisted of a cash account and a change of assets account. Amendments to the Budget Law were enacted, effective from 1 January 1991. They satisfied some demands arising from the prior introduction of the new Cantonal Accounting Model. The key elements of this reform included:

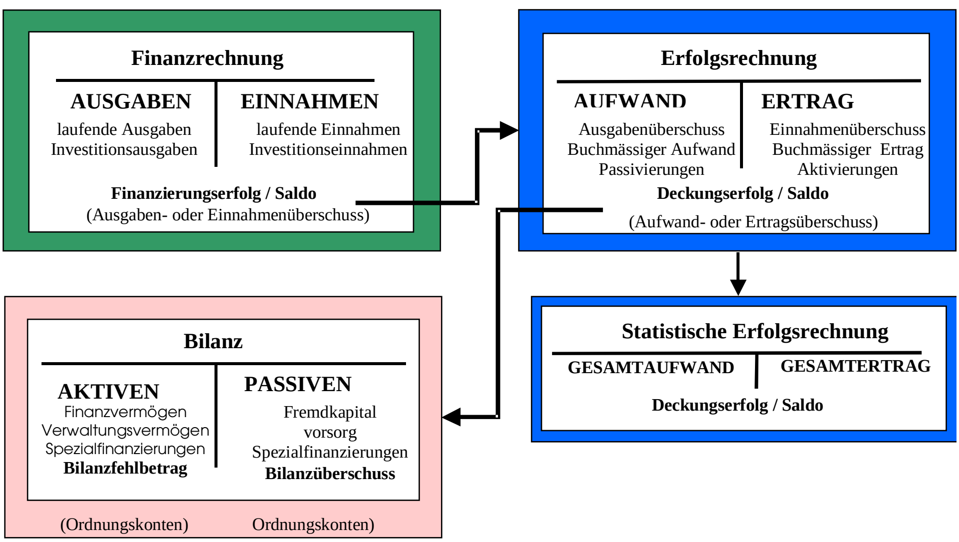
- the requirement for a profit and loss account to supplement the cash accounting system;

- a virtual alignment of the federal account structure with the existing cantonal accounting model;

- the introduction of a credit instrument, which enabled the Confederation to adhere to the target time allowed for payments over several years;

- the establishment of a central treasury management function for the Confederation, the postal and telecommunications services and the federal railways.

Figure 1. **Federal Accounting Model**



Despite such changes, some important peculiarities remained at the federal model. Most notably, cash accounting remained the main management instrument for short-term parliamentary and administrative control. The budget law amendments improved the transparency of certain transactions, but failed to secure the implementation of a real accrual accounting system.

The Managerial Phase. The accounting reform measures at the federal level have had a very limited impact on political debates, even though there have been persistent tensions between promoters of cash accounting and promoters of accrual accounting. Federal accrued accounts are submitted annually but political debate is still dominated by the cash balance. Since 1994, the reorganisation of the fiscal equalisation system between the national and the cantonal levels has been a dominant topic for public financial experts. This debate is likely to go on for the next few years. This project follows the philosophy of a new public management, but transfer payments were the only reform in financial management. In 1997, however, a critical move towards new budgeting methods took place. An amendment to the budget law was proposed as part of a wider reform package to subject lump-sum budgets to the condition that: *a)* public service cost accounts are maintained; and *b)* performance and performance agreements are imposed.

In response to the information needs of increasing decentralisation and corporatisation at the federal level, and following the logic of New Public Management, the debate on implementing a comprehensive accrual accounting and budgeting model started in 2000. It is expected that the Swiss Parliament and its committees will start with in-depth discussions in Summer 2001.

Several measures were also taken to improve fiscal transparency in reporting to Parliament. The pension fund for federal civil servants was separated from the general budget in 1997. Since 1998, the major railway projects have been financed through an extra-budgetary fund, which is not part of the ordinary (*i.e.* operating) budget. The Federal Post and the Swiss Federal Railways were corporatised in 1998 and 1999, respectively. Both have been taken off the federal budget. A basic model for the introduction of cost accounting was developed in 1999 and will be introduced in information technology and telecommunications departments within the administration. In 1999, the government published its first "Financial Vision Statement" to provide guidance for national fiscal policy.

In sum, the latest phase was determined by a stronger focus on managerial demands as a reaction to the dominating public finance view, which made public management reforms difficult. Additionally, the general trend towards de-regulation and liberalisation of former public service markets such as electricity, postal services, railways or telecommunications was a major driving force for the above reforms.

3.2. Federal budgeting, planning and monitoring

In keeping with the cash-based emphasis of the federal financial accounting model, federal budgets merely report payment flows structured according to the expenditure and revenue categories of the various institutions. Even now the federal budget system still does not have a product and hardly has a task orientation. Although the profit and loss account is kept as a supplementary instrument, its high degree of aggregation makes it useful only for computing the overall balances for the entire federal administration. The Swiss Parliament decides on a legally binding, line-itemised budget. The whole budgeting process lasts for approximately 10 months, of which three months are used by parliamentary committees.

The Report on the Parliamentary Program for the Term of 1991-1995 was the first report to formalise the connection between federal finances and functions by mentioning both aspects together. Every four years, Parliament takes note of this report, which also covers the agenda for the coming parliamentary term. Each functional area is divided up into key aspects, and each of these is assigned objectives to be pursued and actions to be undertaken by the federal government. However, there are still only few performance indicators to measure the achievement of objectives.

3.3. Federal auditing systems

As a consequence of a military procurement scandal and following a debate on the strength of the administrative system, the 1967 Financial Audit Act was passed, together with a subsequent Budget Act effective since 1 April 1969.

The Financial Audit Act focused on two main areas of financial control. The first would provide ongoing monitoring of the regularity and legality of government expenditure. The second required periodical examinations of government accounting records by the Federal Finance Inspectorate (*Eidgenössische Finanzkontrolle*, the Swiss supreme audit institution). In 1994, a partial revision of the act strengthened the legal position of the audit office as an independent external review body. It sought to secure the office’s authority and independence by placing it under the direct authority of the Federal and National Councils, which however have no right to restrict the office’s scope of financial supervision. Another revision of the act introduced performance audits, which are concerned with the economy, efficiency and effectiveness of public services delivery. Both these changes followed recommendations made by the Auditing Standards Committee of the International Organisation of Supreme Audit Institutions INTOSAI (1992, 9-21: Guidelines 17 and 40).

4. Financial management in cantons and local government

4.1. The Cantonal Accounting Model

In 1970, after a 30-year period of experimentation with various cash and accrual accounting models in cantons and communities, the Conference of Cantonal Finance Ministers set up a committee to devise a standard system. In 1977, the conference approved a "Public Sector Accounting Manual", which required the implementation of a new full accrual accounting model at cantonal and communal levels in order to secure a greater degree of financial transparency (Stalder, 1995, pp. 311). In 1981, the manual was extended especially in terms of its regulations for communities. To date more than 70% of communities and all cantons have introduced the manual's recommended accounting model. In the late 1980s, financial indicators were developed to facilitate comparisons between the communities and cantons.

The Cantonal Accounting Model specifies key accounting principles and standard account structures for operational and administrative units/activities to facilitate comparisons. Accounts are classified as current accounts and investment accounts. They are structured in terms of organisational units (comparable to "cost centres") and functions for collecting functional cost data. The objectives of the new accounting model, however, have only been partially achieved. Cost transparency remains weak. Smaller cantons and communities complain about excessive details required by the account structure, and costliness of the new accounting systems in terms of time and money. Comparison between cantons are difficult mostly due to the lack of uniformity in using the specified depreciation charges. In good economic times (*e.g.* in the 1980s), most cantons wrote off an amount more than officially allowed in order to build up reserves. In the 1990s, some opted for reduced charges in order to prevent running up deficits.

However, despite such problems, few disagree that double-entry accounting should be generally and consistently applied at this level of government in Switzerland, and a 1997 survey made clear that cantons and communities are in general very satisfied with the model (Stadler 1999, p. 64).

4.2. Planning, budgeting and monitoring at the cantonal level

Cantonal financial planning systems are on a full accrual accounting basis, consistent with the specifications of the Public Sector Accounting manual. Financial planning periods, however, are not uniform, ranging from three to five years (Germann and Weis, 1995, p. 90).

In 16 cantons, financial programs are combined with government directives on functional planning. This provided a relation between performance and finance in the medium-term. The major problem with planning in Swiss cantons lies in the lack of task orientation. Most often, financial planning is an extension of current accounts to combine with a gross investment plan. The increasing dynamics of the public sector, however, would necessitate a differentiated task planning system. The canton of Berne, for example, has just started to move from purely financial line-itemised budgets to results-oriented reporting. Instead of listing general expenditures under various headings, the new approach relates expenditures directly to output/products through product cost allocation and performance indicators. Berne, Zurich and other cantons are now experimenting with a long-term strategic planning process (lasting up to four years) and a short-term budgeting and planning process (including tri-annual reporting) designed to ensure that its products and service are delivered in an efficient and effective manner.

4.3. Cantonal auditing systems

Auditing at the cantonal level is most often administratively placed in the Department of Finance, as in 18 out of 26 cantons. This gives the auditing function a relatively independent status. Six cantonal audit institutions only work for the cantonal government, while 18 accept requests from both the cantonal government and its Parliament (German and Weis, 1995, p. 112). Fourteen cantonal audit institutions are restricted to purely financial audits, while nine of them include management audits in their work. This situation is likely to change in the future with the growing acceptance of the value of a comprehensive audit approach. The leading Swiss organisation representing accounting and auditing professionals (*Schweizerische Treuhandkammer*) has recently published auditing standards for the public sector. These standards include different kinds of compliance audits but not value-for-money audits. This may change, however, due to the fast development of different New Public Management projects in several cantons. In 1998, some recommendations concerning value-for-money audits at the cantonal level were added, including audits of cost accounting systems.

4.4. Cost accounting systems

Several cantons have started pilot projects to implement cost accounting in some departments. In some limited areas, the federal government has a great impact through transfer payments that are restricted to cantonal institutions with a cost accounting system. This is true for example for universities, regional labour offices, or maintenance of national roads. This requirement reflects the need to compare the use of resources for a certain task and to fix the level of national payments to the cantons.

The introduction of New Public Management is seen as a further driving force for cost accounting systems (Stadler 1999). Here, public managers have taken the initiative to urge their governments to let them have these management instruments. Furthermore, some politicians are interested in comparative cost-performance ratios in order to find out whether their own town or canton is efficient and effective. This has also created an increasing public pressure for cost accounting in the public sector.

A new project, named "KOLIBRI", was started on 1 January 2000, to design a harmonised cost and performance accounting model for cantonal and communal use. Initial results are still to come, and it is not clear yet whether a harmonisation of cost accounting systems will be supported by the cantons and their public managers. One would expect cost accounting to be relevant for managerial use only.

5. An analysis of Swiss financial management reform

5.1. The pressure for experimentation and reform

The federal government decided in 1991 to introduce a system of "management control" after testing it in a few projects. Management control is a "method of work which permits management to be monitored in an optimum way, so as to help those in charge to intervene where and when necessary. Management control involves the systematic processing of information whereby it is possible to bring together and evaluate all information seen as essential for management" (OECD, 1993, p. 172). The focus of the management control movement at the federal level, however, was mainly on management information relating to inputs. To date it has not resulted in any significant steps in financial management reform. However, the recent reform initiatives and experiments in the Swiss cantons (*e.g.* Berne) have maintained the pressure for change and have encouraged a move to “Results-Oriented Public Management (***Wirkungsorientierte Verwaltungsführung***) Systems”.

Public administration in Switzerland has traditionally been organised according to the letter of the law, and there is still a considerable reluctance to adopt more flexible managerial methods. especially at the federal level of government. As a consequence, rather than making sweeping, large-scale reforms, experimental legal provisions enabled reformers to disregard particular organisational or budget laws. In this way, they are able to try out new developments and only put them into definitive operation once they have gained sufficient experience. Such tests commenced in various cantons in 1996 and shared the following elements:

Flexible budgeting. Budgets now only contain net figures as legally binding values. Restrictions on transfers across budget headings have been considerably reduced. Budgeting in net figures will now make it possible to exceed planned expenditure, provided this is covered by corresponding revenues.

Cost transparency. A complete assignment of overall costs, which is relevant to decision-making, to products or services will foster a greater cost awareness in administration. In this context, “cost-coverage variables” are being employed to take into account direct costs, controllable costs and overall product costs in comparison to their yields. This system is generating considerable debate about the role of administrative support units.

Performance transparency. This involves the definition and recording of performance in terms of quality and quantity. To date most attention has been devoted to outputs rather than outcomes (Schedler, 1995, p. 159).

Transparency of effects. Initial experiences have shown that the disclosure of performance objectives, indicators and standards fundamentally changed political debate. Discussions no longer concerned with detailed input figures but about the objectives of such purchasing activities and resulting standards of performance. However, there are concerns that politics will shift its attention to what is measured and debate less the objectives of public services, leading to a “dictatorship of indicators” (Knoepfel, 1995, p. 454).

Financial sources. A disclosure of financing for each product group will make more transparent the government’s financial commitment. Many cantons have begun to define and impose cost-coverage levels while leaving it up to administrative units to attain such levels.

Information relevant to decision-making. Experiments have examined different forms and content of information. A great number of unknown quantities remain to be uncovered, particularly with regard to the information requirements of members of Parliament. What is evident, however, is that traditional forms of information are considered to be unsatisfactory by all those involved.

Fiscal equalisation and the level of financial transfers made by the Confederation have emerged again in public debates. These transfers represent a significant proportion of total expenditure, with the Confederation making a contribution to cantons, communities and state enterprises in over 40 different expenditure categories. Fiscal equalisation seeks to eliminate regional disparities, preserve and advance regional autonomy and improve the effectiveness of the task-fulfilment.

5.2. Critiques of the reforms

The changes described earlier have not followed a clear strategic direction as they were not deliberately and centrally driven. Some changes were reactions to purely market forces; others were responses to particular cantonal problems. The debate about New Public Management techniques had a clear impact on financial management in Switzerland. It has, however, not been strong enough to really change accounting or budgeting models on a solid basis. Most of it is still at the pilot stage and have yet to be implemented definitively.

The most common argument for a retention of the cash accounting system at the federal level is based on the fact that two-thirds of the payments made by the Confederation are transfer payments. These can only be recorded in terms of cash payment flows; full accrual accounting is not suitable for them. This position does not take into consideration the remaining third, which could be converted to an accrual accounting system. This results in a situation whereby costly “shadow cost accounts” are kept for individual units to run parallel to the cash accounting system. Attempts to introduce an accrual accounting system have always been resisted by the federal Finance Ministry but there is now an increasing demand for change.

Some researchers and practitioners fear a loss of democratic control if financial management reforms increase freedom of public administrators (Knoepfel, 1995, p. 454). The Finance Committee of the Parliament of the canton of Berne felt the need to play an active part in the reform process in order to meet the challenge of New Public Management (Werder, 1995, p. 9). The due process of law and democracy are not sufficiently considered and their influence on public administrative activities is therefore in jeopardy (Mastronardi, 1995, p. 16).

Although most important for Swiss citizens, the question remains unclear up to now whether the on-going financial management reforms match with direct democratic requirements. Lump-sum budgets are implemented with the intention to widen the room to manoeuvre for public managers. Implicitly, this implies delegated responsibilities and competences for these managers, which means that political influence is kept off operative decision-making. In contrast to this idea, it is a right guaranteed by the Swiss Constitution that citizens or Parliaments can launch an initiative or a referendum that focuses on every political question, even if it is the regulation of decisions which have been delegated to public managers under the New Public Management regime. Today, for instance, initiatives can include highly detailed input restrictions which are systematically alien to the results-oriented management model. Such details can be considered greatly political. In 1998, the purchase of army uniforms was planned to be transferred from the cantons to the federal administration in order to achieve greater efficiency and better prices, and the people decided that the cantons' authority in this matter should be upheld, as a majority feared that a national purchasing office would prefer international suppliers to local and regional ones for price reasons. Nevertheless it could be argued that the level of debate being stimulated by the financial management and associated reforms could well signify a strengthening of democracy. Citizens have become more active in the political arena rather than being passive observers.

5.3. The latest discussion

In 1999, Cemsuisse, the Swiss Confederation of Concrete Producers launched the process of developing a new accounting model for the Swiss federal Government, It sought to implement the recommendations by the former head of the Swiss Audit Office (Probst, 2000). The recommendations contained the following elements:

- implementation of the accrual accounting and budgeting systems;
- reporting with a consolidated profit and loss statement, a cash flow statement, and a balance sheet;
- aggregation of the single offices' accounts at the ministerial and the federal level;

- wherever possible, implementation of single-line budgets combined with performance contracts;

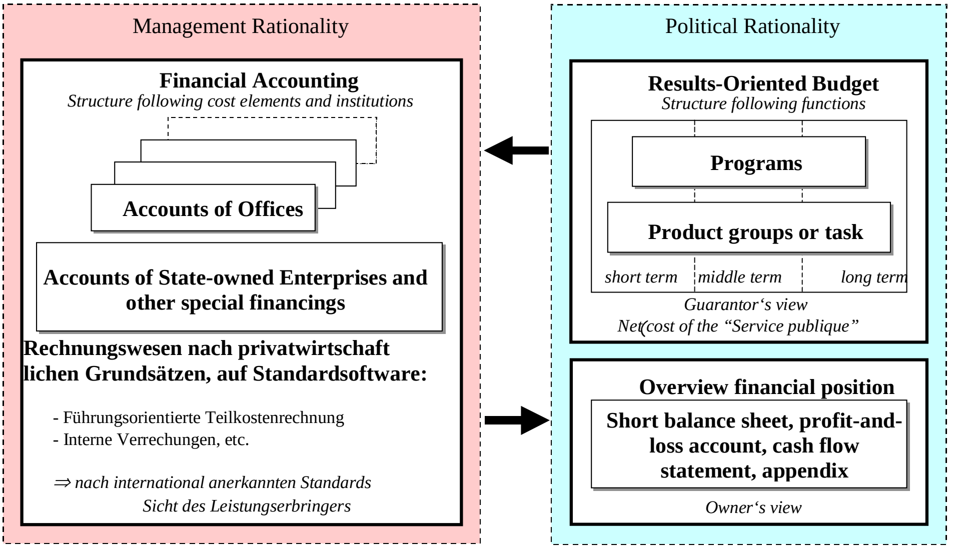
- focusing parliamentary control on the middle-term budget, using a task and finance plan;

- increasing the relevance of annual reports as a control instrument for parliamentarians.

The proposed model used as a guide the International Public Sector Accounting Standards (IPSAS) recommended by the International Federation of Accountants (IFAC). It did not copy the cantonal model, although this could have been expected. This means that, if the federal government decides to introduce an accrual accounting model using IPSAS, the cantonal model will have to be reconsidered too.

A draft model developed by an expert group of researchers, practitioners, and consultants was submitted in the Fall 2000. It is expected to be discussed in parliamentary committees in the Summer of 2001.

Figure 2. **Proposed accounting model for the Swiss Federation Government**



Source: Schedler/Knechtenhofer 2000.

5.4. Conclusion

The introduction of the New Public Management philosophy in Switzerland, most notably at the cantonal level has resulted in some related developments in government budgeting and accounting. The evolution from public finance theory to a results-oriented public management has resulted in a new kind of financial management. The integration of financial management by product budgets and performance measurement has just started at all three levels of government. The focus is now on the integration of outputs and inputs. The shift of control over outputs toward outcomes and impacts has yet to follow. Decentralisation is generating new needs in monitoring and reporting, specifically in terms of performance and effects. New Public Management is just one of the elements of change. Other components of the financial reforms are fiscal equalisation, de-centralisation, and also market forces resulting from liberalisation and de-regulation in international and European markets.

Swiss democratic traditions, preferences for piece-meal experimentation, and the relatively positive views of public services represent an attractive combination. These have possibly allowed the public sector to work constructively towards new financial management systems designed to suit its particular needs. There clearly remains much work to do and problems to overcome. But the agenda for change is, in many respects, a positive one.

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ANNEX 1
FINANCIAL MANAGEMENT REFORMS SINCE 1950

Year	Federal level	Cantonal level
1958	• Financial Management Law enacted	
1965		• Financial planning in St. Gallen
1966	• Introduction of long-term financial planning	• Financial planning in Geneva, Solothurn, Schaffhausen • Accrual accounting in Appenzell-Ausserrhoden
1967		• Financial planning in Zurich, Fribourg, Glarus, Obswalden
1968	• Public Audit Law enacted	• Financial Planning in Berne, Basel-Land, Thurgau, Uri and Nidwalden
1969	• Public Budget Law enacted	
1970	• Introduction of four-year legislative planning	• Financial Planning in Basel-Stadt
1975		• Financial Planning in the Grisons
1976		• Financial Planning in Lucerne, Schwyz • Cantonal accounting Model in Ticino
1978	• Connection between financial and performance planning made law	• Design of the Cantonal Accounting Model; introduction in Appenzell-Ausserrhoden, Neuschtel.
1979		• Cantonal Accounting Model in Appenzell-Innerrhoden, Jura, Zug
1980		• Cantonal Accounting Model in Nidwalden, Valais
1981		• Cantonal Accounting Model in Basel-Landschaft

1982		• Financial planning in the Ticino, Neuchatel • Cantonal Accounting Model in Solothurn, Thurgau, Zurich
1983	• The government decides to keep a cash-based budgeting system, but to complement it with a statistical profit and loss account	• Financial planning in the Valais
1984		• Cantonal Accounting Model in Glarus, Uri
1985		• Financial planning in the Vaud, Zug • Cantonal Accounting Model in Geneva
1986		• Financial planning in Jura, Appenzell-Ausserrhoden • Cantonal Accounting Model in Obswalden
1987		• Cantonal Accounting Model in Schwyz
1988		• Cantonal Accounting Model in the Grisons, Lucerne
1989	• Federal Finance Ministry launches a study on management control to explore its contribution to efficiency and effectiveness, objective-setting, and political and financial management	• Financial planning in Aargau • Cantonal Accounting Model in Berne
1990	• Four pilot projects in management control set up. • Revision of the Financial Management Act, including the 1983 decision of the government	• Cantonal Accounting Model in Schaffhausen
1991	• Decision to introduce management control on a large scale; new series of pilot projects started	• Financial planning in Appenzell-Innerrhoden
1992	• First combined financial and performance plan published	• Cantonal Accounting Model in the Vaud

1994	• Project for a new financial equalisation system between the federation and the cantons launched.	• Studies on public management reforms launched in Berne, Lucerne, the Valais • Irreversible introduction of public management reforms launched in parts of the Zurich administration
1995		• Studies on public management reforms launched in Solothurn, Schaffhausen, Schwyz
1996	• Revision of Financial Management Act	• Introduction of performance budgets in Berne, Lucerne, Solothurn; partly in Zurich, St. Gallen, Aargau • Cantonal Accounting Model in Fribourg
1997	• New Public Management reforms started in selected federal agencies.	• Cantonal Accounting Model in St. Gallen
1998	• Creation of an external fund to finance the great railway projects. • Decision to buy a common standardised accounting software (SAP)	
1999	• Publication of the government's first "Financial Vision Statement" • Basic model for cost and performance account designed	• Cantonal Accounting Model in Basel City
2000	• Pilot projects for internal clearing transfers between agencies launched.	• Project "KOLIBRI" launched to harmonise cost and performance accounting in cantons and communities

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN THE NETHERLANDS
BY
AAD BAC*

1. Introduction

The Netherlands is a decentralised unitary state. Its constitution differentiates between the central government on the one hand and the provincial and local governments, which are autonomous to the extent that no higher interest opposes to it. Therefore, the central government has a limited authority over provincial and local government policy. Provinces and municipalities receive general grants from the central government for implementing their own policy. They are free to determine the allocation of these general grants as well as special grants for the decentralised execution of the central government's policy. Provinces and municipalities have to comply with the so-called "golden rule" of public finance, which requires current expense to be defrayed by current revenue. Deficit financing is exclusively allowed for central government. Therefore Dutch provincial and local governments for a very long time have differentiated between current expenses and capital expenses. They have applied full accrual accounting since the 1980s and prepare balance sheets. The central government does not yet differentiate between current expenses and capital expenses. It is not yet applying accrual accounting, but uses cash and commitments accounting, which is a type of modified cash accounting. Central government will complete the change over to accrual accounting by 2006.

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2. The evolution of accounting in Dutch local governments

The first Dutch municipal accounting rules were promulgated in 1931. The activities of municipalities had increased in diversity and size during the preceding decades. Furthermore, the need was felt to make it possible to aggregate the figures of individual municipalities to arrive at the total for the entire municipal sector. This was important for estimating the impact of the financial policy and management of the totality of the municipalities on the Dutch economy. This total impact together with that of the provinces and the national government exerted certain influences on the development of the Dutch national economy. The beginning of the 1930s marked a period of increasing attention for the macro-economic impact of government involvement in the national economy.

In the 1990s, local governments increased their involvement in non-core business activities, like water purification and distribution, gas and electricity production and distribution, and harbour and market place management. For these types of activities, accounting systems were allowed to be different from the systems for the core public sector.

For the core activities of local government, a cash accounting system was introduced to harmonise the accounting practice of all Dutch municipalities. The cash accounting system of the 1930s differentiated between a current account and a capital account. For investments accounted for in the capital account, specific loans were borrowed in exactly the amounts of the investments. In this way the capital account balanced each year. The interest and redemption on loans was accounted for in the current account. The accounts for a particular budget-year remained open for one year after year-end. In this way the disadvantages of mismatching in the cash system were mitigated. Payments and receipts of the years which had been closed already, were accounted for in the earliest year still open. The accounting system was very prescriptive as far as formats were concerned, and the regulations also contained bookkeeping instructions.

In the period thereafter the role of government, including municipal governments, in society intensified gradually. Municipal governments entered into a series of new services. Increasing numbers of people turned to government for financial support. The Dutch economy grew, as did the role of government in it, due partly to inflation and autonomous growth. The existing accounting system failed to keep up with the information needs of public administrators. That is the reason why the existing system was adapted, at first modestly.

As far as the capital account was concerned, in the beginning of the 1950s it developed into a statement giving more insight in the assets and liabilities of government. This was accomplished by introducing total financing for the complete investment need, instead of specific financing of each new investment. Depreciation accounting was also introduced. Total financing opened the opportunity to better fit the total need for financing, *i.e.* new investments minus depreciation on existing assets plus redemption on old loans. It also helped government to better adapt to a maturity period of loans, as well as to depreciation periods with an economic rationale. This influenced also the accounting for loans in the capital account and the differentiation between depreciation and redemption.

Furthermore, the possibility of accounting for general and special funds in the capital account was introduced. This had two implications. First, the capital account no longer automatically balanced at the end of a fiscal year, because new loans for a number of new investments may have been borrowed just after the year-end and been financed temporarily with short-term money. Second. it became relevant not to transfer the balance of the capital account from one year to the next in one amount, but to specify it by policy area. In this way, the balance at year-end showed the book value of the investments per policy area, separate from the total balance of loans. In the same way the balances of funds at year-end were transferred by policy area. Mandatory statements with compulsory formats specified these book values for individual assets, giving insight into the original investment, depreciation, depreciation period and book value. The same insight was provided with respect to the funds. This was of enormous importance when the balance sheet was introduced over 30 years later. Dutch municipalities did not have serious problems in identifying their fixed assets, as other countries experienced.

A consequence of the changes in the use of the capital account was that the redemption of loans was no longer accounted for in the current account. The current account contributed to the capital account for depreciation, *i.e.* in the reduction of the remaining book value. Payments for loan redemption were accounted for in the capital account in reduction of remaining loan balances.

Furthermore the need to differentiate between payments and receipts of previous years and the current year was recognised. This was accomplished by reporting the amounts of payables and receivables at the moment of closing the accounts. This gave the opportunity to calculate the accrual amounts of expenditure and revenue of a policy area. This evolved a modified cash accounting system. The accumulated figures could also be used to construct a balance sheet. The balance of the capital account as a whole indicated the net need of long-term capital at the end of each year. The balance of each chapter indicated the book value of the investments in each policy area or the remaining debt or the balance of funds at year-end. Despite the adaptations of the old cash system and the “upgrading” towards a modified cash system, the old rules increasingly proved to be inadequate in the support of a uniform classification of public service functions as well as for comparative budget analysis. It did not answer either to the need to simply determine the levels of cost of each service function, because payables and receivables were not really accrued.

Important steps were taken in the direction of accrual accounting, because the information about accruals could be derived from the accounting system. Nevertheless it would take more than 30 years before the conversion to full accrual accounting would be made. This reform was delayed for so long because of the discussions between statisticians in the Ministry of Finance and accountants in the Ministry of Internal Affairs among government officials. After a long period of debate and deliberation, the development of information technology opened possibilities to serve several different goals with one accounting system. This marked the period in which differences in opinion could be bridged.

After the introduction of new accounting rules for provinces in 1979 (effective as of fiscal year 1982), in 1982 new accounting rules for municipalities were promulgated to take effect in fiscal year 1985. The most important change was the application of accrual accounting, which amounted to a technical consolidation of the adaptations of the old system. This led to the introduction of a balance sheet with the inherent valuation questions, as well as the recognition of payables as cost and of receivables as revenue at year-end.

A second major change replaced detailed prescriptions for bookkeeping and the format of statements with regulations aiming for quality of information. The philosophy of substance over form in the Dutch Civil Law on Financial Reporting began to influence municipal accounting regulations.

These major changes resulted in a cultural shock for the financial officers in the municipal bureaucracy. Most of them had been educated and trained in performing accounting in a strict system with prescribed bookkeeping rules and mandatory statements with a compulsory format. The intended advantages of the accounting reform could only be realised when these financial officers could successfully become professionals able to deal with qualitative requirements instead of detailed prescriptions. That is the reason why the reform provided extensive training programs.

A second result of this foreseen circumstance was the retention of certain statements to assist financial officers who would still need assistance in making accounting choices.

A third result of this circumstance was the introduction – by the Ministry of Internal Affairs and Kingdom Relations, together with the Association of Dutch Municipalities and the Association of City-managers – of a program to stimulate the improvement of Dutch municipal financial reporting. This has been called the BBI (*Beleids en Beheers Instrumentarium*, or policy and management instruments) process. This project aimed at the improvement of Policy and Management Instruments in and around municipal financial management and reporting, in order to provide better support of the municipal government's decision-making. The BBI-process has exerted a huge amount of influence on the qualitative improvement of Dutch municipal financial reporting. A kind of competition emerged from this project because some front-line innovators among financial managers in municipalities became ambitious in being in the lead of innovation. Among the many municipalities participating in this competition, the City of Tilburg became well-known all over the world for its financial management and financial reporting.

3. The 1995 accounting reform in provincial and local government

3.1. Reasons for reform

The overall reason to change the accounting system was to better meet the demand of local governments to operate in a business-like manner. Provinces and municipalities produce some services that are amenable to business management. This gave rise to management accounting and accrual accounting.

Initially a number of practices were maintained, such as the formats of statements and the treatments of some types of transactions. The rationale of this strategy was to facilitate the transfer process and to help accounting staff to keep pace with the change in procedures and techniques. A major educational program was started and consultants were engaged to help implementing the new system and to improve financial reporting.

The second step was made in the mid-1990s after provincial and municipal governments had adequately adapted to the new system and were expected to be able to cope with a next step. This step entailed the harmonisation of accounting regulations for provincial and municipal governments with legislation of private sector on financial reporting in the Civil Code. A limited number of departures from the Civil Code were retained because of the specific characteristics of government institutions and as a result of compromises. Since that time, common opinion has been reached with respect to the majority of deviations and compromises. More harmonisation with the private sector is possible. So a third step is expected soon.

3.2. The 1995 Accounting Rules

The 1995 Accounting Rules for both provinces and municipalities aimed at improving understanding of the complete condition of a province or a municipality. The reform was based on four basic assumptions:

1. The Civil Law on Financial Reporting, applicable to the private sector, should be used as a reference as much as possible and justifiable under the motto “Harmonise where possible and differentiate where necessary”.

2. The democratic principle should be supported along with the constitutional principle of autonomy of the provincial and municipal governments.

3. The rules should be harmonised.

4. The change should increase information value.

The provisions of the 1995 Accounting Rules are summarised below.

Matching Principle. The matching principle refers to recognising cost in the period in which the usefulness of the expenditure will be experienced. This principle was not changed by the 1995 reform. Since 1985 the chosen accounting basis is full accrual accounting. The bookkeeping methodology is double-entry. Since accounting regulations no longer contain any bookkeeping prescriptions, the opportunity exists to freely shape the accounting system and make it suitable for management accounting as well.

Economic categories. For provinces in 1979 (applicable from 1982) and for municipalities in 1982 (applicable from 1985). slightly different sets of economic categories have been defined. These categories include traditional cost categories such as the cost of personnel, capital and goods and services, as well as transfers. They also include macro-economic categories, such as purchases of property, plant and equipment, granting of credits, lending and financial participation. Their revenue counterparts are sales of property, plant and equipment, reductions in granted credits, as well as participation and borrowed capital. These two sets of categories were transferred unchanged to the 1995 regulation, thus missing a chance to harmonise them. When the regulations were adopted, an analysis did not offer any good reason for the differences, except perhaps for the sake of longitudinal comparisons of figures.

Functional classification. In 1979 and in 1982 two tailor-made sets of functions -policy areas – were defined for the provinces and the municipalities respectively. Of course these sets differ substantially because the two levels of government have different tasks. Since there had been no complaints as to the relevance of the defined sets of functions, there was no reason for any change. In contrast with the situation concerning the economic categories, a harmonisation of the different sets of functions would not have been a logic development.

Comprehensive financial accounts. In the past and also during the period between 1985 and 1995, the financial accounts of a province or a municipality consisted of a set of financial accounts for its different organisational entities, such as housing, land development, public works and social security payments. Usually these were independent departments of a single public legal body. Separate financial accounts were prepared for each of these entities. These official accounts, called "general service," for purely governmental activities were required to be accompanied by the financial accounts of all the "subsidiary" entities. Additionally, if such an entity was a government sector organisation, its financial accounts were also integrated into the accounts of the general service on a gross figure basis. This means that the figures were to be included for each public service function and for both revenues and expenditures separately. If such an entity however was a government enterprise organisation, its financial accounts were integrated in the accounts of the general service on a net figure basis. This means that only the difference between revenues and expenditures would be included in the respective public service function.

Entities of a government enterprise character since 1985 have come under the Civil Law on Financial Reporting. For government sector entities, this influence did not happen until 1995. The choice for this different method of integrating figures of organisational subsidiaries had an economic rationale. As a revenue-spending organisation, the government enterprise entities could be defined as non-core business activities, now that they were at least partly revenue generating. As in the private sector, this is an argument for not consolidating figures. In revenue generating organisations, even being part of government, specific mandates are not necessary for control and do not disturb the allocation process.

After the 1995 reform not only government enterprise entities, but also government sector entities were subjected to an accounting rules regime that had taken Civil Law on Financial Reporting as a reference. This was for the legislator an argument for ceasing this different way of integrating figures. The budget principle of universality requires encompassing all activities of the government in the budget on a gross figure basis, in order to facilitate an optimal allocation of resources. A direct consequence of this principle is a comprehensive set of financial accounts. Unfortunately, this has resulted in a loss in the quality of financial reporting because it neglects the different economic characteristic of these two types of entities.

Voluntary consolidation of third-party entities. The new regulations offer the possibility to encompass in the consolidated accounts not only all the different component entities of the government itself, but also other legal bodies to which it has granted credits or to which it is entitled to appoint board members. The activities assigned to such legal bodies will be assumed to be government's activities at arm's-length. These include:

- real participation in government-owned limited companies;
- co-operating institutions of different governments;
- government-controlled foundations.

Since the government operates simultaneously from several structures, good co-ordination and a good insight in what is happening are essential. Consolidated accounts may be useful instruments in this respect.

In general, this option should be restrictively used to improve the quality of decision-making. It is advisable to limit this type of consolidation to 100% participation or majority participation in which the control of the "owner" entity is significant. The difficulties in a well-executed consolidation process should not be underestimated. This needs good consolidation procedures and agreements. Government is not yet accustomed to such procedures at all. This is the reason that earlier we spoke of integration of figures instead of consolidation.

The seeming abolition of the capital account. The 1985 reform introduced or maintained three different formally compulsory accounts. These were: *i)* the current account for real current revenue and expenditure; *ii)* the distribution account for revenue and expenditure transactions which had to be distributed over several different functions or policy areas; and *iii)* the capital account for real capital investment expenditures and capital revenues.

The distinction between the current account and the capital account was important to give meaning to the “Golden Financing Rule”. These accounts are residuals from the old cash-accounting system. They reflect the budget authority of the elected representatives regarding the capital expenditures and capital revenues. The former sets of rules (provinces 1979 and municipalities 1982) had made a well-considered choice for maintaining a recognisable method for the officials who had to work with it by providing guidance of a compulsory format of the capital account.

After 10 years of development, new criteria can be used in the choices of the compulsory elements of financial reporting. There is no doubt that authorisation of capital expenditures and capital revenues cannot be abolished. Nevertheless, it is not necessary to maintain a separate statement in the financial reports. So the 1995 reform introduced an investment statement and a financing statement as a compulsory element of the explanatory notes to the financial accounts. These statements give information on position and changes in book values of property, plant, equipment and work in progress, as well as on book values and changes in borrowed capital. It has been discussed whether it would be acceptable only to authorise the consequences of investment and financing, such as depreciation and interest, in the current account. This option was not chosen, because it was felt that the depreciation figure would not help the elected representatives understand the long-term effects of investments sufficiently.

In the new situation, after the investment decision is made and the budget is authorised, their consequences are reflected in the middle- to long-term budget and in the annual budgets. The annual figures are then presented in the investment and financing statements at the end of the fiscal year. A government may freely choose the format for such an investment and financing statement.

Asset Valuation Standards. Under the 1995 Accounting Rules, governments may no longer value their assets on a replacement cost basis. Only historical cost is allowed now. This measure has to do with the removal of the difference between the government sector and the government enterprise sector. Since all the entities of a public legal body are now consolidated, it is important to have one uniform valuation standard for the whole budget and for the whole of financial accounts.

Although this standard has been justified by the removal of the sector distinction, it is the logical consequence of insisting on one consistent valuation standard. So, in the new rules, a choice has been made for historical cost or acquisition cost. In a revenue-spending environment, this was and is a logical standard. There, the philosophy is that every generation has to bear its own cost. Valuation and calculation on an actual cost basis would mean that savings are made for the future generations. However, since capital investment by government is most often financed with borrowed capital, there is no economic need for such savings.

The second aspect of the valuation of assets deals with the method of depreciation. The depreciation period may differ according to the types of assets. The useful period for an office building will be much longer than that for an ambulance. The rules state that the depreciation period has to be in-line with the expected useful life of an asset. Straight line depreciation is used in most cases.

For current assets some modifications are allowed. Stocks and securities are valued at acquisition cost or lower market value. Receivables are reported under deduction of provisions for uncollectible amounts.

Intangible assets can be depreciated over 10 years, in contrast to the private sector where this is five years. An exception is allowed for two special cases of intangible assets: the cost of debt capital contracts, and capital grants for assets owned by third parties. An alternative to the latter could be an annual rent together with a compensating subsidy. Efficiency and underlying responsibility of the users may lead to the choice of third-party ownership. The matching of usefulness and cost implies the possibility to capitalise. For these two exceptions, the depreciation period can be increased to the contract period of the loan or the useful time of the asset respectively. Except for the last example of an intangible asset, the similarity between the rules and regular Civil Law for Financial Reporting is striking.

The balance sheet of a government shows additional fixed assets, *e.g.* streets. A period of usefulness can be defined and historical cost can be indicated for the calculation of depreciation expense. However, the representation of the book value of such an asset is completely different from that of an office building, for instance. Streets and bridges in general do not have realisable values, which to a certain extent are comparable to the book value. The International Public Sector Accounting Standards, which are being developed now, allow the recognition of an asset not only if there is an expectable flow of resources to the entity, but also if the assets have “service potential”. In such cases, the valuation standard is adequate for the purpose of matching of cost and usefulness on the current account only. So the value on the balance sheet of a government may contain some book values with a valuation significance, but in general it will be a statement of remaining book values not yet amortised. As a result the rules require: “The balance sheet with the explanatory notes give truly, fairly and consistently the financial position and the composition thereof in assets and liabilities at the end of the fiscal year”. This is different from the situation in civil law, which refers to “ the size and the composition of capital at the end of the year”. Several compromises were made in the area of asset valuation, some understandable such as carrying as an asset of losses and the use of appropriated reserves. Others are less justifiable or understandable, such as the preservation of “old” book values for assets no longer in normal use, and result-depending depreciation.

Regrettably, the explanatory notes to the new Accounting Rules continue the possibility of depreciation without an economic basis, as when the depreciation period differs from the useful period. If this is accepted, the requirement of consistency is violated. Although these explanatory notes advise against this option, there is no clear indication of the acceptable number and character of cases. This opens doors for abuse. Extra depreciation can only be acceptable in an economic way of judging if and when circumstances have arisen to cause a shorter useful period than originally expected.

Information requirements instead of compulsory statements. The most important evidence of the move of the 1995 Accounting Rules towards “Civil Law on Financial Reporting” can be found in the following provision. Article 27 of the rules states: “The statement of revenue and expenditure with the explanatory notes give truly, fairly and consistently the magnitude of all revenue and of all expenditure, as well as their balance”. Previously, the information wanted was prescribed by means of compulsory statements with a fixed format. The new rules go together with some illustrative statements, but provinces and municipalities are free in choosing the method of producing and presenting the information.

This more flexible approach appeals to the professional ambition of the financial officers. It is evident that the quality of information outweighs rigid standards.

Cost allocation sheets instead of distribution account. The distribution account, which was introduced in 1985 in order to prevent the exaggeration of revenue and expenditure totals because of transitions from one function to another, was a part of the financial accounts. This essentially bookkeeping problem could as well be solved in the accounting system without visualising them in a separate account. That is why after the 1995 reform this separate account was replaced by a compulsory statement, which is part of the explanatory notes, with the format of a cost-allocation sheet.

Apportionment of administrative expenditure. The 1995 Accounting Rules requires the complete apportionment of administrative expenditure (*e.g.* the cost of the official staff) to the functions or policy areas. It may be questioned whether this provision deserves a positive judgement. Allocated cost should be separated into controllable cost and non-controllable cost in order to increase the usefulness of the financial accounts for evaluating accountability. Moreover it is also better to consider whether excessive cost division are cost-efficient. The cost allocation sheet can perform a useful function in making these cost allocations transparent.

Improved middle- to long-term budgets. Governments publish not only financial accounts, but also budgets and middle- to long-term budgets. The 1995 Accounting Rules have introduced a middle- to long-term budget as a compulsory complement of the budget for a fiscal year. Such a budget should be structured by function or policy area, in order to facilitate a transparent view on the future expectations at the service-level and on the space of governmental decision-making.

The budget should present the foreseeable consequences of existing policy that forms the basis of forecasts in the middle- and long-term. It should contain an educated guess of the extrapolated cost and revenue and the size of the provisions and reserves. The reasons for the differences between the fiscal year's budget and the middle- to long-term should be commented, *e.g.* due to especially price indexes and wages. Higher level government could also use the analysis to find out whether the projected service levels could be continued with a balanced budget. A deficit position on the middle- to long-term budget may lead to measures to prevent it.

The explanatory notes to the 1995 Accounting Rules suggest to add to the middle- to long-term budget information about considered policy for the coming years. This could be informative indeed but should clearly be separated from the essential information referring to the existing policy. It is preferable to introduce in the explanatory notes to the financial accounts, a paragraph dealing with an analysis of the results in comparison with the fiscal year's budget and the consequences thereof for the middle- to long-term budget. Such a comment may offer insight in the consequences of recent findings on the middle- to long term financial perspective of the organisation. The budget might also have an addendum giving assurance that the budget does not contain hidden reserves.

Compulsory risk disclosure. The 1995 Accounting Rules prescribe a paragraph on risk in the explanatory notes to the fiscal year's budget and then to the middle- to long-term budget. Risks refer to dangers that threat to inflict damage or losses as a consequence of internal or external circumstances. The budgets should give reliable information on the relevant risks that are of an actual character at the moment of presentation of the budget. Of particular concern are the risks for which no provisions have been made in the financial accounts. If the risks are not quantifiable, it may not be possible to say which part of the general reserve can no longer be used as a normal buffer for unexpected losses or deficits.

Of course the information rendered should not cause damage to the organisation on itself. So the type of information may be influenced by the chance that third parties would take advantage of the information. In extreme cases the information can be given in a closed meeting of the elected representatives. It is regrettable that the 1995 accounting rules do not indicate that a risk paragraph should also be given to the financial accounts. It is clear that the reserves shown in the balance sheet may need the additional information on risks in order to be judged as good as possible. This information could perhaps be logically combined with the disclosure of hidden reserves.

It is a good thing that an increasing number of provinces and municipalities are voluntarily giving a risk paragraph in addition to the financial accounts as well. A change in the regulations to this point may be expected.

Improved distinction between reserves and allowances. The 1995 Accounting Rules introduce a much clearer distinction between reserves and provisions. Furthermore the treatment of these capital components is shifted in the direction of Civil Law on Financial Reporting. Provisions are only allowed if they are for quantifiable financial liabilities or financial risks. The magnitude of a provision must be at level with that liability or risk. Additions to or extractions from provisions originate exclusively from changes in the necessary magnitude of the provision or from expenditure on the purpose of the provision. Therefore adding interest to a provision is explicitly prohibited.

The 1995 Accounting Rules describe reserves as capital components with the character of equity, free for spending or available for covering risks. Decision-makers in an organisations can earmark parts of this equity in advance, by indicating a specific appropriation. This is the first category of "appropriated reserves". Other appropriated reserves may originate from the outside, when special conditions for spending have been made on receipt of resources. Before 1995 this type of appropriated reserves were called funds, which are discontinued under the 1995 rules. A third category is the equalisation accounts against rate fluctuations and equalisation accounts for investment funds to be amortised. They also belong to the appropriated reserves, because they are not liabilities or provisions in the way defined above. In deviation from Civil Law on Financial Reporting the adding of interest to reserves is not prohibited.

Distinction between notes and general report. The 1995 reform introduced distinction between the explanatory notes to the financial accounts and the transmission of a letter of political management to council. Recently, in 1997, this was accomplished with a compulsory general report. The Provincial Act and the Municipal Act require political management to report on financial management in their general report. The compulsory general report differs from the explanatory notes in the level of objectivity of the information. In the general report, information of a subjective character, *e.g.* expectations and policy evaluations, may be given. In order to avoid misunderstanding about the character of the information given, a clear distinction between the general report and the explanatory notes must be made.

4. Central government accounting improvement

The Dutch central government consists of 14 ministries. Each minister has a individual political responsibility towards Parliament. At the beginning of a fiscal year, every minister presents his or her own budget proposal to Parliament. Upon approval by Parliament, the budget of a ministry or department becomes a separate law. This creates a risk of compartmentalisation of public administration.

The application of accrual accounting in government accounting has a very long history in the Netherlands. The first unsuccessful attempt was made in 1916. During the intermediate period between 1927 and 1976, a distinction was made between the current account and the capital account, but it was abolished in 1976. In 1989 the cash accounting system was adapted by the introduction of the recording of commitments. This system is nowadays in use as the commitment and cash accounting system.

As discussed in the previous section, since the mid-1980s, accrual accounting is being introduced in provincial and municipal governments. In the early 1990s, the Minister of Finance presented a discussion document on the possible reintroduction of the distinction between the current account and the capital account. This was not followed by any action. In the mid-1990s, accrual accounting was introduced for agencies. Thus the discussion on accrual accounting seemed to have been concluded. It came to life again after the accounting reforms in New Zealand, Australia and the United Kingdom. In September 2000 the Minister of Finance announced that further steps towards accrual accounting for central government would be taken. This process would take place gradually. Accrual accounting would be initially introduced for parts of departments but not agencies, which do not execute core government tasks. Introduction for central government as a whole would be the next step. It is expected that this transitional process will last until 2006. Possibly the outcome of the International Federation of Accountants (IFAC) Public Sector Committee's project on International Public Sector Accounting Standards. The Memorandum accompanying the presentation of the budget 2001,which is to be expected in November 2001, will be of some influence here.

The Minister of Finance has decided to start a program directed at the improvement of financial management before the general transfer to accrual accounting. Recently, in May 1999, a project was started, aiming at the acceleration and improvement of the quality of the budget and accountability cycle. Within the Dutch central Government, more attention is being paid to integral management and outputs. This has produced a more result-directed approach of business management within government. The Ministry of Finance issued some policy papers on this subject under the following titles: "From Expenditure to Cost" and "Steering towards Result". In June 1998, the report "Financial Reporting in the Political Arena", setting out the goals of accountability, was presented to Parliament. This year's policy paper, called "From Policy Budget to Policy Accountability" is the elaboration of the outline sketched in the 1998 report.

As a result of this project, the budget of the fiscal year 2002 and the financial reports of this year must be more in-line with the general policy of government. This means that a relationship must be drawn between policy, performance and resources – both proposed and realised. Therefore the cohesion between budget and accountability would be strengthened. Furthermore the cohesion between general explanatory remarks and specific explanatory remarks would increase. Information and communication technology can be of much help in realising these ambitions.

The conceptual framework of the new budget document as well as of the future financial reports will: *a)* provide an explanation on the policy priorities; *b)* give an overview of policy goals and financial information for each policy area; *c)* pay separate attention for business management; *d)* provide information on agencies; and *e)* include an appendix on important financial aspects.

Policy priorities. In the budget proposal every ministry presents a so-called policy paragraph with policy priorities for the coming year. Specific policies selected to receive special attention should be effective communicated. The discussion in Parliament could concentrate on these items. The financial effects of the priority order shall also be presented in headlines, explaining explicitly and especially the contraction and the growth of the diverse budget elements, that are the effect of the priority order.

Departmental financial reports will, after the end of the year, logically look back on the extent of goal-realisation of the policy priorities as well as on the financial outcome. An important new phenomenon in this respect is that ministries are expected to indicate relationships with other departments in achieving policy goals in which they have related tasks. This is a welcome contribution to the limitation or even mitigation of the negative effects of compartmentalisation, which are inherent risks of the Dutch system of public administration.

Policy performance and resources: The policy budget. In order to be able to draw a direct connection between policy, performance and resources, all financial data (commitments, expenditure and revenue) that relate to the same policy goal should be presented on one and the same policy budgetline. Together with financial data, where possible the policy goals will be expressed in performance information. Also new is a paragraph in the explanatory notes discussing the factors which will be dominantly influencing the realisation of the policy goals. Altogether this should create the conditions to improve resource allocation.

Relevant information on agencies will be presented in the new budget and financial reports in the "agency paragraph". The policy reasons of ministries for expecting certain products or services from agencies will be found at the respective budget lines of the departmental budget. In order to achieve a greater accessibility and timeliness of the budget and the financial reports, the new possibilities of information communication technology shall be broadly used.

Accountability on budget and policy results. By giving policy a more central place in the preparation of the budget, the point of view of the financial reports also changes. The realisation of policy goals will be more visible in the financial reports. The greater integration of accountability on policy, performance and resources is expressed in the departmental annual report, which is the new denomination of the financial reports. Not later than the third Wednesday in May these annual reports will have to reach Parliament. In this way a substantial acceleration in comparison to actual practice will be achieved.

More compact business management. The financial report of each ministry will contain a business management paragraph discussing the diverse aspects of the internal functioning of the ministry. Business management means the use of all resources available for the execution of policy, such as staff, equipment and information. The business management paragraph of the financial report will deal with regular business management themes in a generalised manner and will specifically enter into special business management themes, as well as in bottle-necks, thus covering actual aspects of business management in the ministry.

National government-wide financial report. Individual ministerial responsibility has led to budgets and financial reports for each minister. However, a general financial report dealing with the national government as a whole thus far does not exist. The preparation of such a report can be reasonably foreseen. This report is expected to deal with the financial relationships of national government as a whole, containing both the results of macro-economic policy and government-wide business management items.

5. Summary

The Accounting Rules for provincial and municipal government in the Netherlands have gone through a long evolution since 1931. By 1995, reform reached a certain level of maturation. The rules have been made up according to the philosophy that deviations from Civil Law on Financial Reporting should only happen if they are necessary because of the demand of information of high quality. Differences in the character of private sector and public sector organisations give rise to necessary adaptations of financial reporting regulations. The guiding philosophy is: "harmonise where possible but differentiate where necessary". The 1985 and the 1995 Accounting Rules gave an interpretation of what harmonisation was possible without losing sight of the differences. Earlier sections discussed the level of success in this harmonisation process. Evolution never really stops; so serious attention on the character and sequence of adaptations is necessary.

Although the national government has lagged behind in comparison with lower level governments, the national government is now also in the process of evolution of financial reporting. Policy choices in the past with respect to the deferral of completely shifting to accrual accounting to the future may be subject of discussion, but now the line has been resumed again. The recent developments, with the initial results due in 2002, are expected to lead to the improvement of budgeting and accounting for enhanced accountability. The complete implementation of accrual accounting, expected to last until 2006, will complement this by making the central government's accounting system more suitable to integrated financial accounting and management accounting.

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GOVERNMENT BUDGETING AND ACCOUNTING REFORMS IN FRANCE
BY

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1. Introduction[1]

In France it is customary for people to see the state as having forged the nation down the centuries, so the role and importance of general government remains great. If one measures the importance of the state by the proportion of public finance in the economy, France ranks near the top of the Western industrial countries, just behind the Scandinavian countries.

1.1. Components of public finances

Specifically, 52% of France's gross domestic product (GDP) is made up of public expenditures and 45% by tax revenues. This seven-point difference is explained by the deficit (approximately 1% of GDP point at the present time) and non-tax public revenues. These figures are the outcome of the steady expansion of the public sector since the early 20th century. The impetus came from the wars of the first half of the century and the development of the welfare state in the second half. Today over half of French public expenditure is devoted to social transfers.

This rise in the importance of public finance has not slowed down, despite the economic problems of the last quarter century. There are clear signs, however, that it has been tending to level-out in recent years. This can be attributed to the trend toward globalisation and deregulation, which reached France in the second half of the 1980s.

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French public finances comprise three components:

- Central government finances, under the direct control of the government account for roughly one-third of the total revenues and expenditures. The central government budget funds the state's core functions, such as defence, law enforcement, education and culture, as well as a number of economic intervention programs, such as employment, transport infrastructure.

- Welfare programs account for around 45% of the total public expenditures. They provide healthcare, pensions, family allowances, and unemployment benefits. Historically related to agreements between trade unions and management, these programs are managed by the social partners of government under contracts. In this respect, France belongs to the group of Western nations whose traditions owe more to "the Bismarck tradition" than to the "Beveridge tradition".[2] Nevertheless, welfare has gradually come under the increasingly tight control of central government, which is responsible for its financial balance. In 1995, a major reform put the French welfare system under the control of the central government.

- Local government finances play a modest role in France, amounting to only 18% of total public expenditures. This is hardly surprising in a traditionally centralised state. Local authorities – mainly municipalities and *départements* (equivalent to provinces in other countries) and, more recently, the regions – have responsibilities at the most basic level, such as roads and environmental protection. They also contribute increasingly to the administration of education, culture and sport, and local complements of the national welfare programs.

For the sake of completeness, it should be noted that 2% of French public funds goes into the European Union budget, which is used primarily to fund agricultural and regional aid.

1.2. Interdependency among the components

The components making up the French system of public finance are not independent of each other. There are two reasons for this situation. First, budgetary boundaries are frequently adjusted when expenditures are transferred from one budget area to another. These are matched, in theory, by corresponding transfers between the relevant revenue lines. Second, the components are linked by ongoing fund flows, especially from central government to local authorities and welfare programs. Nearly a quarter of the central government budget is used to fund local authorities and welfare institutions.

Within this complex configuration of participants, the central government nevertheless plays the key role. It is the traditional holder of legislative power, especially taxing power. It has always exercised close control over local finance in the past, and this now extends to welfare funding. Such central control has been expanding recently, due to the establishment of the European Union and the creation of the single currency, the Euro, and the efforts toward economic convergence this entails, notably improved control of public finance. Rules for the supervision of national finances, accompanied by sanctions by European institutions, lain down in the various treaties, oblige national governments to better control their own budgets and tighten supervision of the finances of local government and welfare institutions.

1.3. Influence of European integration

French budgetary policy is now dominated by European concerns. It is no longer at the discretion of the French Government alone. It must meet standards for economic sustainability defined by European Union (EU) treaties and monitored by EU headquarters in Brussels. The aim is to achieve fiscal balance by limiting deficit to no greater than 3% at the bottom of the economic cycle and national debt to less than 60% of GDP.

A national debt now at 58% of GDP puts France in a relatively favourable position. This is a reflection of sound budgetary policy in the last few decades. The country's current deficits are, however, a cause for concern. Although the present healthy economic growth is generating surpluses for many Western industrial countries, France still has deficits of approximately 1% of GDP. However, it is expected that a balanced budget will be achieved by 2004.

A better understanding of the fiscal performance of the French public sector requires some knowledge about the French budgetary system and the underlying principles. These are discussed in the next section.

1.4. Characteristics of French public governance

First and foremost, France is a highly centralised state, in which Paris, the national capital, continues to play an important role. The presence of governmental institutions is very obvious at local level. The Prefect represents the central government in the country's 95 *départements*. Local authorities have enjoyed genuine independence only for the last 20 years.

The French civil service has five million people, or one in five salaried employees in France. Among the government employees, "career" civil servants, who hold university degrees, are recruited by means of competitive examinations and enjoy life-time tenure. Public service is the bastion of trade unionism, which has never been strong in France in the private sector.

In the area of public finance, legal rules are numerous and have great importance. Legal compliance is closely monitored by both internal and external control systems. Specifically, a distinction is drawn between the commitment of expenditure, which creates a debt, and actual payment, which extinguishes it. This is the organisational backbone of French public finance, and a core principle of our public institutions.

After this broad outline of the French budgeting system, the following sections will offer a diagnostic analysis of the strengths and weaknesses of the system, a description of the reforms being implemented and planned, and a discussion of the key factors for successful reform based on the French experience.

2. The French budgeting system

Rather than attempting an exhaustive description of French budgeting mechanisms and organisation, this section will define the features that most distinguish the French system from those of other countries. This approach, while subjective and open to criticism, is a useful way to convey the essence of the French budgeting system.

2.1. The dominant role of the Ministry of Finance[3]

The power of central government's budget control instruments is all gathered together in the hands of the Minister of Finance. As some studies (*e.g.* Von Hagen) have emphasised, the Ministry of Finance is a major power in France for both the preparation of the budget and its execution. Generally speaking, France's 1958 Constitution ensures significant dominance of the Executive over Parliament. This is especially true for the budget. The government applies a special fast-track procedure for voting on the budget acts. While they retain some power over tax revenues, members of Parliament have virtually no power over expenditures. They cannot increase proposed expenditures, nor can they modify the overall financial balance of the budget as initially defined.

In addition to its tremendous power over the budget, the Ministry of Finance is very prominent in other ways. It has a staff of almost 200 000, including a highly qualified elite with higher salaries than the rest of the civil servants. Since the various restructuring programs in recent years, the Ministry of Finance has expended it competence beyond the financial domain -tax, public expenditure and debt – to the economic sphere – banks and financial markets, competition, consumer affairs, statistics, foreign trade – and industry (energy, telecommunications and so on). This wide-ranging portfolio makes the Minister of Finance a political heavyweight, the government's *de facto* second most powerful person.

The Ministry of Finance plays a central part in shaping the budget procedure during the administrative phase. It steers this procedure by defining the parameters and timetable. Other ministries, standing at the receiving end of budget instructions, have no part in defining the overall budgetary strategy. Even the Prime Minister intervenes only on a few key issues, and may even delegate his decision-making powers to the Minister of Finance in some cases. During the parliamentary debate, the Minister of Finance is virtually the sole performer. He tables and defends the budget draft, even during the examination of the specific budgets of individual ministries.

The power of the Ministry of Finance can also be seen in the actual execution of the budget. It may cancel appropriations by means of an official order requiring only its own signature. It has not hesitated to exercise this authority in recent years to cope with cyclical economic downturns. The ministry can also increase the amount of appropriations, although it must use a more cumbersome procedure that requires ratification by Parliament later. Within the limits of the budget, the Ministry of Finance has enormous power to transfer, reallocate and carry forward appropriations. All in all, approximately 20% of any budget will be modified by government decisions, without any real scrutiny from Parliament. Lastly, but most importantly, expenditure implementation by each ministry is closely controlled by two groups of civil servants under the direct and exclusive authority of the Ministry of Finance. These are the *"controleurs financiers"* (financial comptrollers) in each ministry who co-sign expenditure commitments, and the accountants *"comptables"* (accountants) who will make payments only once they have thoroughly satisfied themselves as to their legitimacy.

In this way, the Minister of Finance has gathered together a diverse and powerful armoury of tools for budgetary control. International comparisons show that he holds, in this respect, an exceptionally strong position compared with his foreign counterparts. French achievements in terms of "sustainability" may no doubt appear modest. But the explanation for this is more likely to be found in political considerations, than in any inadequacy of the technical tools available to the Executive.

2.2. Central financial control

At the technical level, the second characteristic feature of the French budgetary system is the centralisation of accounts. At both local and central government levels, all public funds are deposited to a single central account on a daily basis. This very old unified budget rule goes hand-in-hand with another just as fundamental and long-established rule in the French system. That is the separation of the functions of commitment officers and accountants. The commitment officers are responsible, under the authority of the financial comptroller, for their ministry's budget appropriations, but they do not handle those funds. The actual payment of expenditure and collection of revenue is the monopoly of accountants, all of whom belong to a special directorate within the Ministry of Finance. Each of these accountants is financially liable for the funds under his/her responsibility, and is subject to the judicial control of the *Cour des Comptes*, the French Court of Auditors. The French government accountant therefore performs pre-audit and cashier functions. Their authority and responsibility are considerably greater and broader than accountants in many other countries. More generally, financial management, as a separate and distinct function, is not subsumed under public administration.

This system of central control of cash flows has two major advantages. It optimises cash management and minimises interest costs. Along with detailed and accurate long- and short-term treasury forecasts, such centralisation contributes to the reputation of France's imaginative and creative Treasury department one of the best managers of public debt in Europe. Centralisation also provides good security for the use of public money, since access to cash is strictly monitored. The authorities therefore know exactly where every franc of public money is at any given time. They are immediately aware of all cash flows – incoming and outgoing and this limits the risk of "leakage". Financial scandals in the French public sector have been due more to the corrupting effects of private money on public servants than to any siphoning-off of public funds into private pockets.

2.3. Inadequate popular and politician awareness

The specialisation of public financial management has probably produced an unintended consequences. From the political point of view, it seems clear that neither public opinion nor elected representatives have as yet taken the full measure of what stringent budgetary policy requires. France may be equipped with robust instruments of financial control, but it uses them either too rarely or not at all, because the level of awareness remains inadequate on both the political left and right. This is undoubtedly a problem found in many other countries: people want less taxation, but more spending. France, however, does seem to be in an unusual position in this respect. A number of factors serve to explain this phenomenon. First of all, both our history and national culture attach core value to the state and public service, making us more tolerant of their cost. In addition, as with all conservative attitudes and reluctant realisations of the truth, there is probably a lack of information or sufficiently explicit information. The complexity of the French public finance system makes it opaque and incomprehensible not only for the public but also for many politicians. Lastly, an obsession with the here-and-now and the short-term makes us short-sighted.

2.4. Operational management

From a more technical point of view, our public finance system is obviously weak in operational management. This weakness stems from the focus of our entire administrative and budgetary structure on means rather than ends. Budget classifications are structured by category of expenditure rather than objectives. There are numerous and thorough *ex ante* controls, but *ex post* audits are weak. Guidance and control of public expenditure are thus directed not at performance but at compliance.

This characteristic should be viewed in relation to the importance of the rule of law in French institutions. Nothing is ever done by a government department before a legal rule is laid down. This need for generally applicable rules, which accompanies centralism, can also be explained by a strong attachment to the equality of citizens in their relationship with the state. The same rules must apply to all.

Finally, one can associate this imbalance between means and ends with the dominance of intention over action found in the Christian morality of the Latin world, but not in Protestant thought. The latter being more pragmatic, pays greater attention to results than the means deployed, and, by the same token, attaches even less value to declared intentions.

This concludes the discussion about the central government.

2.5. Emerging local government sector

At the local level, local authority finances are sound, and their budgets and accounting systems meet modern management criteria. In financial terms, local budgets are under control. The decentralisation reform program of the early 1980s, which was conducted against a background of economic difficulty and within an archaic fiscal framework, might have justified fears of a deterioration of the financial situation in local government. Such fears were unfounded, with the exception of isolated crises in a small number of local authorities about 10 years ago. Overall, local authorities are even generating surpluses at the present time. They have the resources to pay back their debt and make a positive contribution to the policy of sustainability associated with the introduction of the single currency. However, one must add that the balance achieved in local finance owes a great deal to generous transfers of revenue from the central government budget in varied forms: subsidies, tax revenue guarantees, cash flow guarantees and others.

In addition, local governments have steadily modernised their budgeting and accounting management methods at a more rapid pace than central government does. Indeed, French local authorities are frequently used as testing grounds for landmark national budgeting experiments and innovations. They played a part, for example, in establishing a clear distinction between operating and capital costs, and more recently in both the adoption of accrual accounting and the "pre-budget orientation" debate.

2.6. A further assessment

We can also try to make a more comprehensive assessment by using an analytical matrix developed by World Bank experts. The matrix has three levels. At Level 1 – aggregate fiscal policy – the French system, as reinforced by the Treaties of Maastricht and Amsterdam, can probably be counted among the best. The French Government has the best instruments for the effective application of any required degree of control over budgetary policy. However, while this is true for the short- and medium-terms, we lack tools for steering budgetary policy with a view to the long term. At Level 2 – resource allocation – the French system appears very limited. This level is usually the least satisfactory and no doubt the most problematic in most countries. France makes almost no use of evaluation, multi-year programming or program reviews. Public debate on budgetary choices is non-existent. This means that the breakdown of public expenditure is afflicted by a high level of inertia. Level 3, operational management, deserves a more mixed assessment. While it has a very strong component in cash management, it is still highly unsatisfactory in terms of effectiveness and efficiency because it is focused on employing resources rather than on achieving results. On the basis of this analysis, one may conclude that the quality of the French system is very inconsistent: its great strengths are offset by serious weaknesses.

The dangers of this lack of balance, due to the interlinking of the three levels described above, should be emphasised. We can anticipate risks in a situation where very strict budgetary discipline is combined with weaker allocation and management. Budgetary stringency is dangerous if it does not go hand-in-hand with modern management. In most cases, this combination will lead to across-the-board funding cuts. In fact, the reverse should happen. The less public money there is, the more allocation needs to be targeted, and the more effectively it must be managed. Indeed, one might wonder if the opposite does not apply in France. Perhaps the abundance of public funds has contributed to the maintenance of an archaic system, as if we wanted to foster the illusion of financial discipline to compensate for laxity in budgeting at the macro-level.

3. Budget reform in progress

The critical picture described in the previous section should not, however, lead one to overlook the improvement efforts, however limited they may be, that over time help to modernise our system. By happy coincidence, we happen to be on the verge of a fundamental reform of the Organic Budget Law, which could lead to a massive switch to a more modern budgeting process in France.[4]

3.1. Recent improvements

We should begin, however, by summarising the improvements made in recent years, which have – without any "big bang" – contributed to a modernisation of our system.

Maastricht Treaty. We will not deal again here with the extremely beneficial and radical effects of the Maastricht Treaty on the system as a whole. Control and supervision procedures have gradually led to the introduction of new concepts and approaches. These include a concern for consolidation and coherence in the system; the introduction of multi-year programming procedures; and transparency, with more detailed, more broadly-based information. It is still too soon to arrive at any overall assessment of the impact of the Maastricht Treaty on the budgetary systems of the countries of Europe. All we can see today is its macro-economic effect of shrinking deficits, which is certainly the most important point. But Maastricht is also having an impact on organisations and procedures in European countries.

On this same macro-budgetary level, significant efforts have been made to increase transparency and information. Specifically, a monthly budget update has been regularly published since 1995 and a budget orientation debate is held several months prior to the formal tabling of the Budget Bill.

Decentralisation. Decentralisation, in its many forms, has also progressed, in France, where it does not come naturally. Decentralisation is first and foremost to the benefit of local authorities. For almost 20 years after the key reforms in 1983, the role of local government in national life has been expanding steadily. In financial terms, this means that a growing percentage of the public purse is managed by local elected representatives, at a level closer to the general public. This shift toward decentralisation, which entails a transfer of power and resources from central to local government, has been accompanied, within the structure of central government itself, by an expansion in the role and resources of locally based civil servants at the expense of the civil servants in Paris.

One last sign of decentralisation is that central government departments are increasingly organised as independent agencies. This has been practised so much so that it could even be said that this is now, in principle, the rule. A government department acting as a service provider will be set up as an agency. Only upper-echelon departments exclusively devoted to overall design and guidance of public services are still structured in the traditional manner.

This multi-faceted trend toward decentralisation has important financial repercussions in terms of contractual appropriations, accounting information systems, tools for guidance and control, and budgetary federalism.

Managerial autonomy. At the same time, there is a visible shift in the direction of greater autonomy for managers, who now have more room to manoeuvre. First and foremost, budget appropriations are now more broadly based. This is particularly the case for the central government budget, in which appropriations are divided up into “chapters”, the number of which has fallen very substantially from 4 000 in 1945 to approximately 800 today. The rules governing the employment of the funds concerned have been updated. Those applicable to government procurement, though still very many, are to be made more flexible in 2001. Payroll management has also become less rigid. Control of employment remains strong, but limited adjustments in salary levels are now possible. Management of real estate assets has been made more dynamic.

Financial information. Finally, budgeting and accounting information has been improved. As a result, the presentation of budgetary documents of the various ministries is now clearer. In particular, the figures for appropriations in each chapter have been accompanied by statements of objectives and results over the last few years. The basic philosophy underlying public accounting is changing gradually from a cash-basis to an accrual-basis. This trend began in municipal authorities (with regulations called M14) and is now spreading to the *départements* and regions. The welfare system accounting will switch in 2002. Lastly, central government has introduced accrual accounting for budget year 2000.

This improvement in the quality of budgeting and accounting information is underpinned by extensive development of the use of information technology in all departments, at both macro- and micro-budgetary levels. A very large project called ACCORD is currently in progress. It is based around a single software package that integrates budgeting and accounting data and is intended for use by all ministries. After several years of preparation, its deployment will begin this year in a small number of ministries.

3.2. Reforming the Organic Budget Law

The above recent developments have raised the prospect of a major upheaval. That is the reform of the Organic Budget Law, which dates back to 1959 and has remained unchanged for the 40+ years since then.

Parliamentary initiative. The initiative behind this reform came from Parliament, which prepared a bill that is currently being debated. The parliamentary origin of the bill is, in itself, of the greatest significance in the context of a system dominated by the Executive. Its main political objective was to return some financial powers to Parliament. The initial reaction of the Ministry of Finance was, for this reason, unenthusiastic. Nevertheless, the other dimension of the project – modernisation of public management – was eventually seen to be a highly positive factor, and this helped bring the Ministry of Finance on board.

The political environment, therefore, looks to be favourable for the bill. The positions of Executive and legislature have converged toward a robust agreement on broad principles. In addition, the project is backed by a broadly-based consensus on both right and left in the country, as is shown by the constructive attitude of the Senate, which is dominated by the opposition, and the enthusiastic encouragement of the President of the Republic.

While it is not certain that the project can come to fruition during the run-up to the elections, we can nevertheless look forward with confidence to the implementation of the reform at some time in the future[5].

Greater parliamentary control. The project's first part is aimed at giving more control over public finance to Parliament. This is reflected in the reinstatement within the general budget of some non-budgetary funds, parliamentary involvement in in-year management of appropriations and an extension of the right to amend government proposals. Alongside this, the quality of information provided has been enhanced. The application of accrual accounting has been generalised, including off-balance sheet commitments. (Parliament would like to go further, extending the accrual-basis to budgeting itself, but the outcome of this debate is not clear.) A multi-year programming phase in the annual budget preparation procedure has also been introduced.

Shifting from means to ends. The second part, which could shift French administration toward a new approach to public management, is fundamental. The 800 budget "chapters" would be replaced by 100 to 200 programs corresponding to the various tasks assigned to government departments, and would be presented using a multi-year approach. Within the limits of these programs, managers would have greater room to manoeuvre, encompassing payroll, which constitutes a radical upheaval in French government administration. Such a shift of the basis of administration from means to ends naturally entails detailed monitoring of results. The bill therefore provides for the development of activity and performance indicators and a switch from *ex ante* controls to *ex post* evaluation.

To a large extent, the bill thus assimilates the components of modern public management as practised in certain Western industrialised countries. A large number of analyses and surveys, as well as considerable travelling to gain a better understanding of what other countries are doing, have provided input for its drafting. For many years, analysis of foreign systems was of interest only in narrow academic circles. Fortunately, this is no longer the case today. More and more practitioners are looking for ideas, experience and examples from abroad. This new openness to the outside world is probably among the factors that have helped galvanise French administration.

4. Key factors for the success of budgeting reforms

There are many such factors. We will identify those that appear crucial and deserving of study and discussion with foreign colleagues.

4.1. Political commitment

It is an unoriginal observation that reform in the public sector cannot succeed without strong support from the national government. This is of course true of any budgeting or accounting reform. However, we should nonetheless add that the commitment of any government will be genuine, that is, more than simply the expression of pious hope, only when it is driven by strong demand from the general public, or by some external shock. Pressure from the general public seems to have been a major factor in recent moves toward reform in a number of Western industrial countries. Such pressure can take two forms. The first can be a demand for higher quality from users of public services. The second is a feeling on the part of taxpayers that the tax burden is becoming overwhelming. The relative importance of these two factors may differ according to country and period. In France, pressure from the public is not particularly marked as yet, although it seems to have been gathering strength in the last few years – more because of tax pressure than in reaction to the quality of public services – it is still weaker than that seen recently in some English-speaking nations.

External shock. The external shock caused by the creation in Europe of a single market – and currency – has been a major factor in stimulating national governments' enthusiasm for reform. The combination of tax competition – linked to the single market and driving a reduction in the tax burden – and the budgetary discipline imposed by the single currency, is forcing European governments to adopt very strict management of expenditure and, consequently, a modernisation of their methods for management of public finances. As we have already said: the less public money available, the better it needs to be managed and allocated.

The necessity of political support from the government for reforms, which in the case of France, are closely associated with external pressure, calls for two further comments concerning public finance.

Better communications with politicians. First of all, public finance is a highly technical, extremely complex field. It is frequently very difficult to bring non-specialists, such as our politicians, to an understanding of the link between the modernisation of public services and technical reforms, *e.g.* the introduction of accrual accounting, budget classifications and cash management. We, as experts and professionals, must therefore endeavour to teach and to communicate if politicians are to understand the importance of these issues. In order to make our concerns understandable to others, we ourselves need to understand their concerns. Our technical expertise will be useful only if we can broaden our vision to encompass all the dimensions – cultural, social and political – involved in modernising central government.

Political consensus. Secondly, such political support must be sustained over time, because reform is a long-term project, as everyone knows. Support based on a broad consensus throughout political circles is desirable if it is to last through changes of government. This is the case in France, where broad sections of the political world, both right- and left-wing, share the conviction that administrative reform based on shared views is necessary. However, the picture is not uniform. For example, the political right is more sensitive to the issue of the cost of public services than to their quality, whereas the left can be described as being attentive to the civil service lobby.

4.2. Core group of modernisers

It is important to create, maintain and lead a core of "modernisers" inside the administration. If this is not done, the determination of the government, however strong it may be, will remain ineffectual, because it will not be matched by the same determination at the various levels of the administration. The core group will, in most cases, be composed of highly qualified young civil servants, because they are aware of the changes needed, open to modern methods and keen to express themselves. This group will not necessarily coincide with the managerial echelons, which are more concerned with operational management than with reform. It will of course be desirable to avoid conflict between the old and new guard, which could halt the entire process, but the dissemination of the modernisers throughout the whole administrative structure may well turn out to be an advantage when the time comes.

Management training courses are obviously crucial for the identification and grooming of the core group of modernisers. Specialist schools of administration and universities play a major role in this, and must act as sources of modernisation. The openness of their courses to the international context is important in making their teaching stimulating and enriching, and their role is increasingly important in France, where a government administration with the confidence that comes from several centuries of sound values and high performance is no longer reluctant to look at how other countries do things.

4.3. The human dimension

Technical decisions are less important than the human factor. It will, of course, be necessary to make sure that the technical decisions reached are the appropriate ones, but this is not the most difficult task. Expert assistance and advice will usually produce the best solutions, with the sole proviso, in the case of especially complex issues, that more than one opinion should be sought and more than one solution studied before any choice is made. It is essential to avoid becoming dependent on any single expert, which will naturally require a little more time.

The most difficult task is not the technical design, but how it is applied by human beings. Analysis of reform successes and failures demonstrates that, leaving aside the technical decisions, it is largely the management of the human dimension that turns out to be crucial. As many people as possible must be involved in the reform process, which must be explained, and its advantages for all concerned must be highlighted. Satisfactory solutions must be found for those inconvenienced by the reform, the right teams must be chosen to steer and implement it and all concerned, internally and externally, must be persuaded that reform usually entails difficulties in the short-term that pave the way to improvements in the long-term.

While the technical aspects can be delegated to outside consultants, this is not the case for the human dimension, which must be the central concern of managers. We in France have seen projects where just the opposite has been true. Managers have gone overboard for technical solutions and have relied, where actual implementation was concerned, on outside consultants, who were assigned the task of oiling the wheels a little to limit the ensuing friction.

4.4. Use of trial programs

France's experience leads us to recommend that the greatest possible care be taken in implementing the process, which must be gradual, diversified and decentralised. The use of trial programs is a new component of French reform strategies, especially since the Ministry of Finance departments suffered a major setback in their attempt to reform tax administration early in 2000. In technical terms, the decision to move tax assessment offices closer to collection agencies was a good one, in that no shedding of staff was involved. But it was nevertheless rejected by civil servants by the tens of thousands, and led to a serious work stoppage throughout the country. Analysis of this failure highlights these facts: not only was the social dialogue inadequate, but the approach to implementation was also uncompromising and excessively uniform.

Efforts to modernise were resumed a few months later on different, more pragmatic, terms; notably, each component of the reform is now to be tried out in a small number of test offices for a few months. This method, while it certainly takes longer, has two advantages. First, it enables technical adjustments to be made to the reform project. Second, it is above all conducive to greater acceptance by the staff concerned.

Similarly, it is important to give decentralised management the greatest possible flexibility for adapting reform to local circumstances. It is of course necessary to keep sight of the essential goals, but local managers, who are in the best position for action, must be able to make adjustments to the parameters and pace of change. Such an approach is very much a novel one in a country like France, which is highly attached to the equality of all citizens and all national regions in their relationship with government administration. Nevertheless, government departments and elected representatives are becoming increasingly aware of the problems that arise from the conception we have of public intervention, which is all too often excessively uniform and inflexible. Experimentation has also been undertaken concerning our legal principles.

This change in approach has of course attracted considerable criticism. The government has not rejected this outright, which would have been an absurd and clumsy response. By highlighting the advantages of the new method, it has been able to obtain a large measure of acceptance of this break with fundamental principles.

4.5. Co-operation between finance and other ministries

The role of the Ministry of Finance is obviously crucial in the management of budgeting and accounting reforms. However, its responsibilities must be shared. The ministry enjoys technical and political legitimacy for its position at the helm of such reform. In addition, its part in allocating public funds provides it with a powerful weapon for the encouragement of change. The establishment of a linkage between the allocation of resources and the implementation of reform is a technique often used by many Finance Ministries. However, budgeting and accounting reforms must be conceived and taken forward in conjunction with the other ministries, for it is they who actually provide the public services, have contact with users and spend the public funds. Practical experience of the problems, ideas for reform and consideration for the real constraints all come from the field, and it is this level which must be brought into the process as early as possible to ensure that the reforms are both relevant and realistic, as well as to facilitate their subsequent implementation.

In France, regular contacts between the Ministry of Finance and managers enable views and proposals to be exchanged on a wide-range of technical topics: working groups on real estate, travelling expenses, information technology procurement and so on. Experience shows that this is not always easy. The political procedures and timetable are not always conducive to such involvement of other ministries, and there is also a degree of mutual distrust, even outright hostility, which creates a climate prejudicial to open and constructive dialogue. To overcome such resistance, French public administration is seeking, in the context of the relationship between the Ministry of Finance and the spending ministries, to compartmentalise negotiations on defined issues from discussions focused on joint exploration of ideas and solutions, since the procedures, timetables and individuals involved are quite different. It is, for example, frequently the case that ministries' ideas and suggestions are picked up by the Ministry of Finance for wider application.

Other lessons can be drawn from French experience. The five topics presented here appear to be the most important, and, we very much hope, the most useful for our foreign colleagues. The French budgeting and accounting system is far from perfect, and no one would put it forward as an example to be followed. We do hope, nevertheless, that it can provide useful fuel for thought for those planning modernisation programs.

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NOTES

1. This paper has been written as comprehensibly as possible for an international readership. It uses terminology that is as universal as possible, even if this deviates in many cases from the normal French terminology, which reflects our past history and national culture too strongly to allow its use beyond our national borders.

2. In Europe there exist two major types of organisation for the funding of the social security system. In Germany, at the end of the 19th century during the reign of chancellor Bismarck, a system based on trade unions' agreements, privately run and financed by social levies was created. In the United Kingdom, a report of Lord Beveridge, issued during World War II, became the basis of the National Health Service (NHS), a state system financed by taxes.

3. Presently known as the "MINEFI", an acronym for "Ministère de l'Économie, des Finances et de l'Industrie".

4. Since then, this bill has been voted by the Parliament and became the "Loi organique n° 2001-692 du 1er août 2001 relative aux lois de finances".

GOVERNMENT BUDGETING AND ACCOUNTING REFORM IN ITALY
BY

EUGENIO CAPERCHIONE AND RICCARDO MUSSARI*

1. Introduction

The primary objective of this paper is to offer an overview of the state of public sector budgeting and accounting in Italy. There are four levels of government in Italy: the central, regional (20 regions), provincial (103 provinces) and municipal (8 100 municipalities). Each level has jurisdiction over several service functions and activities. The provinces and municipalities are often jointly referred to as "local governments".

Central and local government are treated separately in this paper for a number of reasons:

- reform bills passed over the last few years have introduced significant changes into both local and central government accounting systems;

- it is possible to briefly discuss the scope of accounting autonomy that national law has granted to local authorities;

- it is both useful and interesting to make a comparison among the solutions specified by the law for these two levels of government.

It may be noted that a reform bill of the accounting system of the regions was only recently passed by the Italian Parliament under Legislative Decree No. 76 of 28 March 2000. This law, being inspired by the reform of the national budget, provides for the basic principles and co-ordination rules in regional budgeting and accounting. It allows each region autonomy in preparing

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and passing its own accounting bylaws. Since this process is still underway, we have chosen not to cover the accounting system of regions in this paper.

For the sake of brevity, this study is specifically concerned with Italian budgeting and budgetary accounting. However, it is worth remembering that the accounting reforms have also introduced management control and cost accounting into both local and central governments.

The rules that govern public sector accounting in Italy are determined by law. Local authorities can define autonomously in their own accounting bylaws the details of such issues as the national law devolves on bylaws, and they can even deviate from the contents of some articles. However, the fact that the underlying assumptions of public sector accounting required approval by the National Parliament entails a few consequences. First of all, the same law-making process is used to enact provisions concerning public sector accounting as for other matters. Therefore, the “circle” of individual and institutional actors that can influence the making of the law is substantially reduced if compared to potential stakeholders. Consequently debates and studies end up following the passage and, above all, the enforcement of the law rather than anticipating and guiding it. The only exception is the research studies carried out within ministries and other branches of the state (for instance, the National Audit Office) or committees appointed by the Cabinet.[1]

In Italy there is a longstanding and important tradition in the field of public sector accounting research studies. At the same time, national professional associations, international organisations and the European Union seem to exert highly significant influence on the legislature. However, the Italian process of making accounting regulations does not institutionally envisage any broad scientific and preliminary debate among all the actors concerned with public sector accounting innovations. Such a practice seems more prevalent in countries where accounting standards are approved through different procedures and by professional accounting boards. Moreover, in Italy, governmental accounting is taught by jurists by academic tradition, which helps to explain the cultural orientation that has prevailed until very recently. A further consequence of the legal regulation of accounting matters is that both scholars and accountants are obliged to make continuous reference to prescriptive texts. Consequently, for purposes of clarity, we also refer to the prescriptive rules as necessary.

2. The creation of responsibility centres in the central government

The creation of responsibility centres, called Basic Budgeting Units, is a key recent innovation in the Italian central Government. This new practice has enabled the Parliament to focus on public policy, while leaving the details to administrative discretion. The chief provisions concerning central government accounting were passed in 1997 under Law 94 and under Legislative Decree 279 that governs its enforcement. Law 94 has the key goal of modifying the framework of the budget and to this end introduced some significant changes to Law 468 of 1988 that regulated this matter.[2] The annual budget includes a document of total government revenues and another document of total government spending broken down by ministry. The budgets of autonomous enterprises and agencies are also enclosed. Each document of government spending is accompanied and illustrated by preliminary notes and is supplemented with a technical annex. The preliminary notes of expenditure set forth:

- the criteria for the adoption of spending estimates;[3]
- the objectives to attain in terms of the level of services;
- employee recruitment that may be planned to occur during the accounting period; and
- the efficacy and efficiency indicators that are going to be used in order to assess results.

The technical annex sets out the itemised elements of each single Basic Budgeting Unit (BBU) and indicates the mandatory or discretionary nature of spending.[4]

The contents of the "preliminary notes", in view of Parliamentary consideration of the budget, take on great importance as the basis for the formulation of the annual policy-setting directives that each minister adopts within 10 days in allocating resources to government executives. On the other hand, when the time comes to define the elements to be included in the spending documents, the ministers "specify the objectives and programs of each ministry also on the basis of the proposals of the executives responsible for the management of the individual forecasting units". Moreover, the "criteria" and "parameters" at the basis of the formulation of financial budget estimates are set out in the Government's Economic and Financial Planning Report.

The subdivision of BBUs into items is carried out by the Ministry of the Treasury in agreement with the agencies involved in management and bookkeeping. The items are determined on the basis of the object in the case of revenue, and on the basis of the economic nature in the case of expenditure.

The national annual budget is still drawn up both on an accrual-basis and on a cash-basis. This means that estimates refer to:

- assessment and collection (actual receipts) in the case of revenues;

- obligation and payment (actual disbursements) in the case of spending.

Parliament ratifies by law both accrual-based and cash-based estimates. The budget performs an authorising function inasmuch as spending estimates establish the limits (*i.e.* spending caps) within which it is possible to enter into obligations and to make payments, respectively. In order to be approved by Parliament, the BBUs are subdivided into units related to current spending and units related to capital spending. A multi-year budget is also adopted, however this document does not authorise expenditures.

The most significant innovation introduced under Law 94 concerns the elements of revenue and spending through the introduction of BBUs that are to be approved by Parliament.[5] Therefore, in the annual budget, revenues are subdivided into headings (source), basic budgeting units, classes (nature of assets) and items (for bookkeeping purposes only). Spending is subdivided into goal-functions (public policies), basic budgeting units and items (for bookkeeping purposes).

The BBUs (Art. 1 of Legislative Decree 279) form the organic set of the financial resources allocated to the management of one single administrative responsibility centre. Every BBU is substantially matched by one single responsibility centre that, following the adoption of the budget, is entrusted with the management of the allocated financial resources (*i.e.* appropriations). Administrative responsibility centres are identified on the basis of the organisation of central government and mostly correspond to the executive offices in each ministry. BBUs are thus identified with reference to homogeneous activity areas over which each ministry has jurisdiction. Within 10 days of the adoption of the budget, the ministers allocate the financial resources of each BFU to the chief executives.

The need to identify BBUs as an aggregate of revenue and, above all, of spending is the result of other reform laws passed during the 1990s. In particular, Decree 29/1993 already provided:

- ministers shall allocate a share of the administration budget to each executive-level department;

- this share shall be proportional to the existing financial resources and related to the proceedings assigned to Executive responsibilities;

- the activities carried out by the executives, including the adoption of all the deeds that result in external obligations through autonomous spending powers, shall be assessed against the manner, timing and costs used in order to achieve the final outcome.

In other words, the reform of the framework of the national budget is the necessary consequence of the distinction between policy-setting and control activities. Policy-setting is a prerogative of politicians, whereas management powers together with their related responsibilities are assigned exclusively to top executives. Therefore, it is Parliament that allots financial resources to specific responsibility centres when it adopts the budget. It is then up to the managers of each centre to use the available resources within the limits and constraints deriving from the division of BBUs into items, for the achievement of the goals that each minister sets out for the administration in an *ad hoc* directive. The most apparent effect of the introduction of BBUs is their substitution for the approximately 6 000 items [votes] of the previous budget, each of which had to be independently and separately approved by Parliament in a piece-meal fashion. Consequently, the national budget is today much leaner, readable, revealing and comprehensible than it used to be.

From an accounting viewpoint, today's greater aggregation of budget items may result in less frequent budget amendments. Moreover, there should be a significant slackening of the tendency to augment the length and scope of parliamentarian speeches during floor consideration of the budget, so that parliamentary consideration would be more general and strategic.

Upon the proposal of a chief executive, offsetting amendments can be made among items of the same BBU. This kind of offset is not allowed among items of different BBUs, unless it is authorised by Parliament under a budget amendment or reconciliation law.[6] The possibility of making offsetting amendments among items of the same BBU should be considered favourable as it proves that the legislature has become aware of how dysfunctional it is to constrain the management within the narrow scope of items. It is now clear to all that the way spending is managed within each single Basic Budgeting Unit, is a managerial choice of the person (Executive) who is then accountable both for the efficiency in the use of the production factors, and for the efficacy in the achievement of goals.[7] Items thus lose the authorising and constraining nature they had prior to the reform, while they continue to be exclusively an accounting tool for the recognition of tax assessments and collections, as well as obligations and payments.

In substance, budget items have been re-unified and re-aggregated into "homogeneous units" through the introduction of BBUs, and the distinction between "political budget" and "administrative budget" has been introduced. The political budget is approved by Parliament that votes on each single BBU, whilst the administrative budget falls under the jurisdiction of the Cabinet, which later breaks down BBUs into items.

When the budget reform was first implemented in FY 1998, BBUs were identified under Legislative Decree 279. For the following years, the identification of BBUs has been left to the various national budget bills that can – from year to year – introduce any modifications and/or supplements compared with prior-year classification. The 2001 Budget Bill (AC 7329), now being considered by the Chamber of Deputies and at the point of going before the Senate, sets out the BBUs for FY 2001. The BBUs related to central government agencies that are included in the 2001 budget bill have increased by 61 units, from 1 286 in FY 2000.

The amendments to the budget framework are partly due to the transfer of functions and resources from the state to the regions and to local authorities (*e.g.* incentives for companies, veterinary care and human health, energy and mineral resources, public works, road network, environment). This is why the resources related to these devolved functions have been provisionally budgeted for in the spending document of the Treasury, in two BBUs containing a current fund and a capital fund. Other changes are too detailed to be covered here.

This more detailed identification of BBUs is justified by the function they accomplish, *i.e.* to ensure the full correspondence between financial management and the goals of government action with reference to particular policies and with a view to verifying the consistency of activities with goals. Under the FY 2001 Budget Bill, the number of administrative responsibility centres has increased by four centres compared with the 2000 balanced budget from 202 to 206.

These brief considerations on the changes to the framework of the FY 2001 budget show that the reforms of central government organisation have an impact on and modify the budget framework. This further emphasises the close link that exists between the exercise of public powers and the use of financial resources, while administrative action is increasingly made a function of the goals of managerial efficiency and efficacy. Therefore, on the one hand, Parliament forgoes accounting details in exchange for a clearer definition of public policies. On the other hand, both the government and the management acquire greater managerial flexibility by justifying in a clearer manner the acquisition and use of public resources and by relating administrative action to specific goals and performance measures in terms of efficiency, efficacy and economic viability.

3. Accrual budgeting and cost accounting in the central government

Further significant innovations that followed the passage of Legislative Decree 279/1997 are the accrual budget and cost accounting by cost centres. These additional innovations have been introduced to make appropriate tools available for the economic assessment of:

- the services and activities produced in relation with the autonomy granted to public managers;

- the results produced by the management, also with a view to determining the share of variable salary linked to the achievement of results.

The new accounting process has been actually implemented in the year 2000 by bringing about the preparation of accrual budgets by cost centre. Once in full swing, the accrual budgets and the ensuing cost measurement and control will not only be indispensable for effective management control, but will also be highly useful for more accurate measurement and justification for the resources to be acquired when developing the budget. In other words, central government agencies are required to prepare the accrual budget of each cost centre, as well as the traditional financial budget.

According to the approach adopted by the Ministry of the Treasury, the definition of the accrual budget constitutes the prerequisite for the application of the cost accounting system. Therefore, an accrual budget must be defined for each cost centre on the basis of programs to be implemented and of goals to be achieved, which are set forth by general managers. This accrual budget must identify the estimated costs on the basis a standard chart of accounts that classifies costs according to their nature.[8]

In order to prepare the FY 2000 budget, cost centres were identified with the administrative responsibility centres specified in the 2000 budget bill. Every cost centre of the central government is required to draw up an accrual budget on the basis of the technical guidelines provided by the Ministry of the Treasury, thereby identifying estimated costs according to the entries in the chart of accounts. It is the responsibility of the General Department for Budgetary Policy (General Accounts Office in Ministry of the Treasury) to take care of the harmonisation and reconciliation of the accrual budgets with the financial budget and to present a specific report of the cost of activities and services to Parliament.

After the budget bill has been passed, the General Department for Budget Policy submits the approved budgets to the various agencies, in order to allow the ensuing ministerial directives to be issued and resources to be consequently allocated. The Ministry of the Treasury (Memorandum 32/1999) suggests the following activities in defining accrual budgets:

- identify cost centres;
- describe the resources needed by each centre to pursue set goals;
- quantify the resources in terms of units of measurement (*e.g.* number of persons or years per person, etc.);
- measure the resources in terms of money.

Since the use of resources is always linked to the possibility of spending in order to acquire them, the economic forecasts of each cost centre should be consistent with budget appropriations.

It should be emphasised that any costs that are not directly associated with the activities of the ministries (even though they are a cost to the state as a whole) are not included in the accrual budgets of the ministries. Examples of such costs include the National Healthcare Fund, general government administrative outlays and the public debt. The General Department for Budgetary Policy enters these costs in one single artificial centre called Central Government Common Costs. Costs that cannot be easily attributed to the individual cost centres of each ministry, are assigned to an artificial cost centre called Common Costs of General Administration. In substance, the purpose of the Ministry of the Treasury is to allow each ministry to support and supplement the framework of the financial budget with an accrual budget and accounting system that are capable of measuring costs, as well as spending.

For FY 2000, cost centres have been identified with general or equivalent executive-level departments that are directly accountable to the political bodies. Cost centres, thus, essentially conform with the administrative responsibility centres identified in the FY 2000 Budget bill. Individual agencies have been required to define a structured system of lower-level cost centres in accordance with their own management control system for each cost centre thus identified.

4. Reforming local government accounting

4.1. Introduction

In 1995 the Italian Parliament passed a measure that introduced some significant innovations in local government accounting. According to their advocates, these innovations would improve the overall quality of decisions and increase efficiency by making available relevant and reliable economic information. At the same time, municipalities and provinces should implement accrual accounting, which would indicate whether local governments are managed by considering intergenerational equity. The whole accounting reform was supposed to be consistent with the recognition of greater autonomy for local government. This followed the 1993 reform of the electoral system, which vested more powers in the mayor and dramatically changed the form of local government accountability.

Now, six years later, many expectations have not been met. There is no proof of significant improvement either in the quality of economic information or in the quality of the decisions taken by local governments. It is thus necessary to document a series of elements of objective difficulty in the implementation of the 1995 reform, thereby discussing their possible causes and feasible solutions. To this end, this section describes the framework of Italian local governments and a short history of reforming their accounting system. It then briefly examines the reasons behind the 1995 reform and the process for designing a new accounting system. The substance of the reform will be analysed in terms of its perceived costs and benefits. Finally, the major gaps between the reform’s objectives and actual effects will be identified and explained, along with some suggestions for re-designing the system.

4.2. Italian local governments

Each Italian municipality has a mayor, a Cabinet, a city council and a professional bureaucracy. The mayor, head of the Executive branch, is elected directly by the citizens and has the power to appoint the members of his Cabinet. The city council is also elected directly by the citizens. Municipalities are allowed to raise local taxes and charge tariffs for the services they provide. However, a large percentage of their revenues (27% on average in 1998)[9] comes from transfers by higher levels of government. The transfers are classified as "current" or "capital" according to whether they are intended to cover operating expenditures or to fund investments. The provinces have a similar system, although their taxing authority is much more limited. Italian provinces play a somewhat limited role in the production of services and act mainly as re-distributors of resources.

Municipalities have always had a pivotal role in the Italian Government system with regard to political representation. They also produce a number of essential services to local residents. These include day nurseries, school lunches and transport, public transport, waste disposal, waterworks, the construction and management of sports centres, public green areas, and nursing homes for the elderly. These services are provided either free of charge or are partially subsidised by taxpayers.

4.3. Local government accounting prior to 1995

Italy has no professional public-sector accounting standards-setting body. The requirements for governmental accounting, reporting and auditing are set by national legislation. Applicable laws are different for the central government, the regions and local governments. However, their common objective has been to curb public spending. As a consequence, they adopted the obligational and cash bases of accounting. In addition, budgeting was viewed as the only relevant phase of the accounting cycle, while financial reports were virtually totally neglected. Finally, bookkeeping was based on the single-entry system in order to emphasise budgetary compliance.

This system had its own underlying logic and largely met the needs of the historical period in which it had been conceived and implemented. In the course of time, however, some totally new events occurred in the system of Italian public administration, especially in local governments. One of these changes concerned the financing system of local governments.

Prior to 1973, Italian local governments enjoyed a great deal of fiscal autonomy. This led to unacceptable differences in terms of their available resources. The reform in 1973 completely modified the financing system of local governments. In the 20 years from 1975 to 1995, there was a progressive shift to the centralised collection of resources through taxation. In other words, citizens and businesses would pay taxes to the central government, which would later allocate resources to local governments. This made financial control at the local level very difficult. Due to unclear allocation criteria, every local administrator would tend to satisfy all the requests for better services made by citizens, in the hope that their costs would be borne by the taxpayers of other constituencies.

The modification of the financing system also had some relevant consequences on accounting. On one side, the Treasury of the central government in Rome was mainly interested in the collection of cash data, in order to manage the financial flows of revenues and expenditures. On the other side, local governments tended to spend the entire amount of the transfers received, because any savings would result in a reduction of transfers the following year. So none of the key players saw any apparent reason to invest in the voluntary reformation of accounting, especially accrual accounting.

Some other events must be taken into account in order to better understand the framework in which the local government accounting reform took place. In particular, throughout the 1980s and 1990s, Italian local governments called for greater organisational, managerial and economic autonomy. Eventually, this request came from the people themselves, so the government could no longer ignore it and promoted the enactment of Law 142/1990. This law provided for greater autonomy of local communities – municipalities and provinces – which were made accountable for carrying out their own functions and were given statutory and financial autonomy. As a consequence of this greater autonomy, local governments have been experimenting since 1990 to spin off their activities. They created separate entities without legal autonomy and separate legal entities with budgetary autonomy. They form consortia of local governments, or joint-stock corporations with private and public stockholders. Alternatively, they have franchised private firms to provide services.

Nevertheless, the accounting system was still based on a 1979 law, which had progressively become obsolete with regard to a number of substantive issues. In particular, both scholars and practitioners highlighted the following limitations, which led to the necessity of a reform:

- short-sightedness of the system. The time horizon of local government accounting and more specifically of financial reports, only covered the short-term, while no reliable information on the impact of policies in the medium- to long-term was available;

- poor readability of financial statements and consequent difficulty in assessing results. This accounting system dates back to a period when the sensitivity to the citizens' right to information was not strongly felt;

- difficulty in assessing intergenerational equity. The incapacity to determine the value of assets and liabilities and to recognise expenses and revenues on an accrual basis, as well as the often immoderate resort to borrowing makes it impossible to assess whether a generation is living "within its means" (Anthony, 1983) or it is consuming resources it is not producing. This situation is by itself an incentive to "non-economic" behaviour, that disregards the balance between generations;

- poor "usefulness for decision-making purposes" of the information generated by the accounting system. Financial resources were allocated to the various organisational units or expense centres of each public entity through the budget, according to a pre-defined framework. Since, for formal control reasons, this framework could not be overridden throughout the following bookkeeping and reporting stages, it took on a predominant role in the administration of public entities. Consequently, the output of the accounting system did not include the production of periodic reports that are organised on the basis of different frameworks, autonomously decided by each single entity and linked to actual management processes (for instance, costs by service unit, costs by project).

Furthermore, there was in many instances a distorted and instrumental use of the accounting system (Borgonovi, 1996, p. 386), that was aimed at supporting requests for increased transfers from the central government, to the detriment of the actual documentation of operating results.

4.4. The impetus for change

Increased awareness of the aforementioned limitations of this accounting system slowly took hold in the late 1980s and early 1990s. There was a widespread consensus about the need for change, even though scholars were divided over the timing and ways of change. The flaws in a system are, however, not a sufficient condition for innovation. In particular, there must be a number of stimuli to change, that make an impact upon the expectations and behaviour of both users and producers of information. On the other side, implementation barriers should not be so strong as to hamstring the start and enforcement of innovation (Lüder, 1994). To this end, we now identify the main stimuli (in Lüder's model) that allowed the reform of Italian local government accounting to be conceived between 1990 and 1995.

The first stimulus to be accounted for is the "fiscal stress".[10] By the late 1980s, the nation's overall financial equilibrium reached an unbearable situation. There was unanimous agreement, even among different political parties, on the need for a global reform of public finance, including of course local finance. In response, Law 142/1990 set forth two basic principles:

- the financial autonomy of local governments has to be ensured; and
- local governments can levy new taxes.

According to these two principles, the structure of local finance designed under the 1990 law comprised the following elements:

- the central government grants transfers in order to finance all basic services;
- it also appropriates specific funds in order to cope with exceptional events;
- the central government may also finance investments which are of primary social and economic interest;
- all other services local governments wish to render must be financed by local taxation or by fees covering the incurred costs.

This revolution in local finance had, and still has, some relevant consequences. For instance, as the central government has recognised a higher level of autonomy of local governments, it will tend to consider local governments responsible for the financial consequences of their decisions. Local governments will then need to ask their citizens the money needed to cover non-basic services or higher quality services. Local communities will also be required to directly finance any deficits of their relevant local governments, as the central government intervenes only in cases of near bankruptcy.[11]

Of course, the reduction of the central government's financial aid and the necessity to ask local communities for money affect people's expectations about the services they finance directly. There was also an impact on the behaviour of politicians, who must account for effectiveness and efficiency to their local communities (Mussari, 1995). However, such far-reaching changes affecting the behaviour of economic agents take place over time. Thus, this law could not spare Italy the 1992 financial crisis, for which local authorities bore as much responsibility as their economic weight, and the subsequent strong devaluation of the Italian lira, due to an ever-growing public deficit.

Consequently, the passage of Law 421/1992 became unavoidable in order to identify the structural causes of the deficit, and to fight against them with determination. The law concentrated on the following areas of intervention, which were later to become the object of separate acts:

- healthcare;
- local government;
- Social Security spending and other so-called statutory entitlements;
- the civil service.

Another stimulus to change came – albeit only indirectly – from the financial scandals of the 1990s. In 1992 it had become evident that the action of some public administrators, in particular the whole area of public procurement, were heavily conditioned by the objective to collect funds for political parties. These scandals triggered requests for new mechanisms of governance and management.

In order to improve governance mechanisms, Law 81 was passed in 1993 to provide for the direct election of mayors and of the presidents of provinces. According to this law, the electorate chooses its mayor and city councillors at the same time. In order to grant the mayor a reliable majority in the city council, 60% of available seats are assigned to the majority slate linked to the elected mayor. The mayor is also given the very important power to appoint and – with some limitations – dismiss:

- the members of his/her Cabinet, *i.e.* the Aldermen;
- the representatives of the municipality in owned and/or controlled enterprises;
- the city manager and the other managers of the relevant LG.

The mayor thus has a strong mandate from his/her constituency and the possibility of really managing the local government. The accountability mechanism has thus also changed. Decision-making powers and responsibility for results are concentrated in a clearly visible person, who must then account to the local community for the actual results of his/her action in terms of output and outcome. In contrast, before this "revolution," the main focus of accountability was simply on the formal compliance with laws.

With regard to management mechanisms, the solution introduced under Law 29/1993 consists in the separation of the tasks and responsibilities of politicians and managers. Politicians – the mayor with his/her cabinet and, to some extent, the city council –set long- and medium-term objectives, allocate resources, and negotiate annual objectives with the managers. Managers are relatively free to take the decisions on how to meet the agreed-upon targets, but are then accountable to the politicians for their efficiency and effectiveness.

All of the aforementioned laws entail a redistribution of the decision-making power within local governments, which has resulted in the need for a new accounting system. In particular:

- the reform of the financing system of local governments requires the accounting system to disclose information about the overall economic condition of the relevant local government;

- the reinforced accountability of the mayor to the local community requires investment in the production of popular reports that are easily readable and understandable by ordinary people;

- the new role of managers, for whom objectives and performance targets are identified, requires investment in management accounting and on performance measures.

4.5. The change process

The aforementioned Law 421/1992 paved the way for the reform of local government accounting. The Ministry of the Interior in 1993 set up an *ad hoc* committee comprising representatives from different professional fields, mainly the chief financial officers of local governments and charged them with the task of drawing up a reform proposal. The goal was chiefly to design a system that would increase the degree of accountability of each individual local government. The reform raised following the expectations:

- every key player should have available information consistent with the kind of responsibility they are assigned;

- citizens and other stakeholders should be kept informed on the achievements of local governments, on the reasons behind failures and mistakes, and on the reasons on the basis of which a single LG establishes price levels and taxation pressure;

- the distinction between roles, tasks and accountability of political representatives and public managers in budgeting, accounting and control;

- the need to understand the cost of programs and services provided to citizens;

- the need for management control systems to help public managers in the decision-making process;

- in general terms, management efficiency and effectiveness and the quality of decisions should be improved;

- the cases of financial crises of local governments should be reduced to a bare minimum to reduce the burden on the entire national community.

Law 77/1995, "Financial and accounting rules for local governments", was eventually designed and passed. However, as the next section of this paper will show, the design and enforcement of this law only partially succeeded in satisfying all the expectations described above.

4. The Local Government Accounting Act of 1995

The 1995 local government accounting reform, provided for in Legislative Decree[12] 77/1995, affects all local governments and envisages a phase-in period ending in the year 2001. We will focus on the innovations concerning budgetary accounting and accrual accounting. An overview of these innovations will allow us to better understand the aims of the decree and to assess the gap between expectations and achievements.

4.1. Budgetary accounting

The 1995 reform upheld budgetary accounting as the pivot of the entire local government accounting system. The budget thus continues to be the fundamental document in the political life of local governments, as it reports all the choices made with reference to the upcoming fiscal year. These choices give rise to legal obligations. Estimated spending in the budget should be "paid for" by revenues of the same amount. Any budgetary deficits should be eliminated in the ensuing fiscal year by increasing revenues or by cutting spending.

The reform may not seem particularly innovative in this respect as it establishes a continuum with prior legislation. Nonetheless, some new rules are enforced in order to make sure that patterns of behaviour comply with the traditional principles behind the law. In other words, any changes made to prior legislation are merely a means of ensuring that the traditional accounting standards are complied with. For instance, the chief financial officer is required to steadily monitor the balance between revenue and expenditure, starting from the budgeting phase in which he/she must formulate an assessment of truthfulness and reliability. The only significant innovation contained in the decree with regard to budgetary accounting concerns the separation of the budget into two documents:

- the budget which must be approved by the city (or provincial) council. Its framework has been slightly modified, with a reduction in the number of *"votes"* and their aggregation by larger public policy areas, with a view to presenting the councillors with the clearest vision possible of the significance of the choices they make;

- the "management executive plan", a document that is derived from the budget and that authorises public managers to spend the resources available to the local government. This document also includes the management goals to be achieved by each manager, who is annually assessed and rewarded on the basis of his/her performance.

This latter document has produced positive effects in local governments, as the managers have been made fully accountable for the achievement of set goals and they enjoy decision-making autonomy they have never had before.

Nonetheless, the reform is not bound to produce positive effects, also because its actual implementation suffers from the discretionary margins that both the mayor and the Cabinet still enjoy, and neither of them is always willing or able to establish a relationship of trust and collaboration with managers. This means that, whenever they feel it advisable, they can adopt measures that somehow limit the managers' margins for manoeuvre. Moreover, this can entail the risk of incurring the same decision-making problems met in the past by public managers. These problems could stem from:

- too much focus on fiscal compliance and accountability instead of managerial accountability;

- too much emphasis on the budget and too little weight given to performance measurement;

- more attention to input than output and outcome since goals and objectives are largely buried in detail;

- little flexibility since deviations from detailed appropriation breakdowns require city council approval;

- little attention to the overall effectiveness or efficiency of organisational units.

4.2. Classifying accounts for budgeting and accounting

Under Law 77/1995, the basic (and smallest) *"vote"* is called "*intervento*" (action). It registers a specific item of expenditure for which the authorisation is granted. There are some differences to the previous system. The most important of these is the fact that there are now fewer items. The most frequently used items of current spending are the following:

- salaries and wages;

- materials and supplies;

- rendering of services;

- amounts paid for leases;

- subsidies;

- debt service;

- taxes and fiscal charges.

In this way the annual budget becomes both clearer and more slender. The city council authorises the Cabinet to spend on a relatively aggregated basis, and the budget need not be changed frequently during the year.

Nevertheless, budget authority for the items to be purchased must be complemented by and interlaced with organisational authority, as the city council specifies the units for which goods and services can be purchased. For this second level of classification, local governments are obliged to adopt a nation-wide uniform list of *organisational units* representing specific operations and/or outputs, such as services for the elderly, traffic control, personnel management, and nearly another 50 units.[13] It should be noted that the units in this list hardly coincide with the actual organisational units found in local governments. It is obvious that a centrally planned list of units can hardly fit more than 8 000 municipalities (and 100 provinces). Budget appropriations are made by the city council with reference to each uniform organisational unit and item of expenditure. Thus, everybody should be able to easily understand what resources are allocated to which service, and to compare this information with prior year data or make cross-comparisons.

4.3. Financial accounting

Besides the reports of budgetary accounting, the Local Government Accounting Act requires local governments to annually produce a statement of operations and a statement of assets and liabilities in a standard format established under Law 194/1996. Double-entry book-keeping, however, is not mandatory. Alternatively, local governments can still use the traditional single-entry obligation- and cash-based accounting system and produce accrual-based financial statements through a system of year-end adjusting entries. Box 1 provides an example of the adjustment process with specific reference to supplies. A specific "reconciliation statement" must be included in the financial statement to reconcile the cash- and obligation-based statement with the income statement.

Box 1. **Producing accrual-based financial statements from cash- and obligation-based accounting: an example**[14]

FY 1998		
Outflows reported in the obligation-based financial statement		
Supplies (*i.e.* orders placed in 1998):		800
Adjustments		
Add:	beginning (= as of 12/31/1997) undelivered orders:	150
Less:	ending (= as of 12/31/1998) undelivered orders:	170

Purchases		780
Add:	beginning (= as of 31/12/1997) inventory:	210
Less:	ending (= as of 31/12/1998) inventory:	240
Costs reported in the accrual-based financial statement		
Supplies (*i.e.* supplies consumed during 1998):		750

Since costs are obtained from expenditure information, this document is deemed sufficient in order to introduce financial reporting based on accruals.

It is true that this simplification can somehow favour start-up, especially in smaller municipalities that are lacking in trained staff and are used to traditional cash accounting. However, critical analysis (Caperchione, 1996) and experience (Caperchione, 2000a) show that this entails a heavy loss of significance in accounting documents. In particular, the main problems stem from the fact that the values of the budgetary accounting system refer to the obligations incurred by an entity, that is a stage in the spending procedure that comes before the actual purchase of a good or service. Nonetheless, many local governments still follow this route, which epitomises their poor awareness of the importance of reliable accounting information.

4.4. The gap between objectives and effects

Some of the above critical observations about financial accounting have been empirically corroborated. A survey found that 49 out of 72 local governments produced accrual-based reports for FY 1997 as required. This leads one to conclude that the real effects of the LGA Act only partly coincide with expectations (Caperchione, 2000a). It should be highlighted in particular that:

- obligation- and cash-based accounting continues to prevail over accrual accounting in regard to all the issues relevant to the functioning of local governments, starting from the definition of current and capital transfers. It is certain that for a number of years pressure will be put more on cash data than on accruals data. This obviously will not generate more attention to the quality of accrual accounting;

- given the different accounting modalities, it is still quite difficult to compare the results of different local governments;

- the new system still does not permit the identification of reliable efficiency and effectiveness indicators that truly help managers to make decisions;

- accruals reports are, at least for now, virtually unusable and do not create any opinion flows or political debates.

Therefore, the reform has failed to considerably improve the levels of accountability in local governments.

This lack of achievement can be traced to a variety of factors. Attention should be concentrated upon these factors in order to propose an alternative improvement path for the functionality of the Italian local government accounting system. If the accounting system reforms carried out in other countries are observed (Caperchione, 2000b; Christiaens, 2000), a top-down procedure has a greater chance of success provided that the following conditions are met:

- the system is planned accurately starting from a conceptual framework and ending in a complex and orderly design of local governments;
- an intensive experimental period follows;
- the aims of the reform are clearly explained together with the significance that should be given to performance, thus creating awareness and consensus;
- accounting professionals enjoy autonomy to introduce adaptations and/or modifications – especially when there are missing links in the project;
- an adequate degree of accounting culture exists within local governments, or the right conditions are created so that those who wish to update their knowledge are facilitated and motivated;
- cultural and financial resources are available for the careful revision of management procedures, that must become consistent with the accounting system, in order to permit the effective and timely gathering of basic data;
- accounting standards especially designed for local governments are made available in a relatively short period;
- more generally, those that impose the reform show an interest in attaining good results, and provide benchmarking occasions, as well as the necessary financial, human, hardware and software resources.

It is difficult to state that these conditions existed in Italian local governments for the last six years. Therefore, it is not surprising that the results achieved have not been in line with expectations in many respects.

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NOTES

1. Compare M. Carabba (1998) on the technical support given by the National Audit Office, the General Accounting Office and the Public Spending Committee towards the reform of the National Budget.

2. See A. Barettoni Arleri (1989) and A. Bennati (1990) on the former budgeting system. For a history of budgeting, see F. Di Renzo (1961), P.E. Cassandro (1979) and G. Zappa - A. Marcantonio (1954).

3. Article 4bis of Law 468 of 5 August 1978, as amended, provides that the appropriations in the each single spending assessment shall be determined solely with relation to the functional needs and feasible objectives of the fiscal year for which the budget is being developed, whilst it prohibits any quantification based on the mere calculation of incremental historical spending.

4. “It is quite clear that the law provides for the preliminary notes and technical annex as the documentary evidence that acquaints Parliament with the connection among the government’s policy, the objectives set for public administration and the resources allocated to responsibility centres. We find this same logic in the new Art. 4bis (Creating a Budget) of Law 468, that provides that “when developing their spending assessments, the ministers shall set forth the objectives and programs of each ministry, also based on the proposals of the executives responsible for the management of each single forecasting unit”. With a view to the development of spending assessments, the Minister of the Treasury “shall assess the charges of functions and of institutional services, as well as those of the programs and projects submitted by the relevant agencies, with reference to individual forecasting units. He/she shall also examine the status of implementation of ongoing programs, with a view to include the residuary outlay in the budget as capital spending already appropriated even though it may refer to obligations outstanding”. Therefore, this process creates a sounder cognitive base to examine the spending projects that have not yet entered into obligations and that represent, on one side, the residuary appropriations and, on the other side, the capital amounts to be spent” (P. De Ioanna, 2000).

5. “As the National Audit Office points out, a more adequate choice would have been to build the forecasting units to be approved by Parliament on the basis of “goal-functions” interlaced with responsibility centres. This would have led to a “budgeting process” truly based on the *ex ante* definition of public policies ” (M. Carabba, 1998).

6. “This approach enacts a sort of exchange between Parliament and the Executive. In fact, Parliament acquires greater capability to assess the profiles of functional re-appropriation and the implied political priorities, and, at the same time, grants more responsibility to the Executive for the management of spending functions” (C. Conte, 2000).

7. There have been a few scholars who have critically observed that “the preventive sub-division into items serves the purpose of retaining some powers to the Treasury, even though it simultaneously reduces the autonomy of the administration ... In fact, it is the Treasury that defines by decree the number, name and contents of the items, in agreement with the individual agencies. The identification of items, thus, entails a power to be exerted by the administration that exerts control over spending” (R. Perez, 1997).

8. During the start-up phase, the Ministry of the Treasury requires that cost estimates be limited to the organisational level of cost centers, thus postponing to a later phase the sub-division of costs by function.

9. *Source:* The author’s calculations based on data from the National Association of Italian Municipalities.

10. *Cf.* Lüder, 1994, p. 7: “There is evidence that the fiscal stress is the main stimulus to initiate a governmental accounting reform”.

11. A special procedure sets the rules for central government financial aid, aimed at facilitating the recovery of nearly bankrupt local governments. Nevertheless, the bulk of the operation lies considerably on the relevant local community.

12. Under Italian Law, Parliament may decide to delegate legislative powers to the Executive on specific matters. The laws enacted by the Executive under these circumstances are called “legislative decrees”.

13. The list of all the organisational units established with Law 194/1996 can be found in the Attachment No. 2. The law also identifies *functions* (“funzioni”), *i.e.* 10 big areas of intervention (such as education, health and welfare, community development, etc.), but these just represent the aggregation of “services”, and have thus no significance with regard to the appropriation process.

14. *Source:* Borgonovi and Anessi Pessina (1998).

GOVERNMENT BUDGETING AND ACCOUNTING REFORMS IN SPAIN
BY
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1. Introduction

Spain is a Southern European country with an area of 506 km². It is mainly a peninsula located between the Mediterranean Sea and the Atlantic Ocean, with Portugal to the west and France to the north. The only Spanish islands are the Balearic Islands, in the Mediterranean Sea, and the Canary Islands, in the Atlantic Ocean, in front of Africa's coastline.

Spain has a population close to 41 million, and is thus ranked fifth among the countries belonging to the European Union, only behind Germany, the United Kingdom, France and Italy. The most populated municipalities are Madrid (2.8 million inhabitants), Barcelona (1.5 million) and Valencia (0.7 million). Spanish GDP amounts to 522 700 million ECUS, which puts the country in tenth position world-wide. Nonetheless, its GDP per capita (at around 12.9 thousand ECUS) is rather low, with regard to the most prosperous countries in the European Union. With regard to tourism income, Spain is in fourth place world-wide, behind the United States, France and Italy.

From a political and administrative point of view, Spain is a parliamentary monarchy. Elections are held every four years. There are three levels of public administrations:[1] the central administration (which is in charge of the whole national territory), the regional administration (each of the 17 Spanish regions, each one with its own Parliament) and the local administration (relative to more than 8 000 municipalities in Spain and their corresponding entities). From 1996, the Popular Party (conservative) is in control of the central government. Regional governments are held by the Popular Party

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(conservative), the Socialist Party (social democrat) and regional parties (as in Catalonia and the Basque Country).

On order to comply with the requirements imposed by the European Union, important efforts have been carried out lately to reduce public deficit and leverage. The debt is now about 60% of GDP and the public deficit is under 2%, even though for 2001 the target is to achieve a "zero deficit" for public administrations. To this end, a new "Act on Budget Stability" is now being developed. This new act aims to increase discipline in the financial actions undertaken by the public administrations at different levels, as we will look into in the next sections of the paper.

As in the case of business accounting, European governmental accounting systems can be classified as European-Continental or as Anglo-Saxon accounting systems. There does not exist a European governmental accounting model. Therefore, the Continental and the Anglo-Saxon systems are the two models used in clustering the different European governmental accounting systems. Hence, the Spanish system is included among the Continental systems, with the features that we describe in other sections of the paper.

In Spain, as in the other countries with a Continental accounting tradition, standards are set by the law or administrative rules issued by public authorities. Accounting standards are applied because they are legally binding and the influence of the accounting profession is very weak. The main objective of financial statements within this tradition has been the fulfilment of legal and administrative rules when reporting financial information. This is also the case of Germany, France, Belgium, Italy and Portugal, in Europe, and the countries with most important influence in South America, as Argentina, Brazil, Chile and Colombia.

On the opposite side, Anglo-Saxon accounting systems have a professional design of accounting principles and standards, set up by private professional accounting bodies. The main objective of financial statements has been the faithful representation of the entities' economic and financial reality, in such a way that transactions and events are accounted for and presented in accordance with their economic substance and not merely their legal form. This is the tradition of the United Kingdom and Ireland, in Europe, and the United States, Canada, Australia and New Zealand.

This duality in accounting models still remains, and it becomes even more pronounced, if possible, among public entities than in the business field (see International Federation of Accountants, 2000a). Therefore, while economic globalisation has strongly fostered harmonisation of business accounting, European public sector accounting has not evolved in a similar way, so substantial diversity still remains.

Until the 1980s, Spain experienced a cultural and scientific lag, as a result of political isolation both within Europe and world-wide. This was a consequence partly of Spain's neutrality in both World Wars but more significantly of the almost 40 years of the political regime following the 1936-39 Civil War. Because this regime was inward-looking, Spanish academics had very few opportunities for international relationships and exchange of experiences. There were even fewer chances for such an exchange in the case of civil servants and officers. Because of these circumstances, the introduction of new ideas and theories depended on very few people, who selected the works to be translated and subsequently published, as well as the foreign experiences which were to be considered. All this inevitably led to important gaps and limitations of perspective, both in business and governmental accounting (Montesinos, 1998: 358-9).

2. The public budgeting and accounting tradition in Spain

In governmental accounting, the Spanish system was limited to the registering and execution of the budget, using the single-entry method. Substantial changes were implemented in the 1980s with the introduction of the double-entry method and the development of an integrated system of budgeting and accounting, as we will see later on.

The traditional budgetary and accounting model for public administrations in Spain places the budget and cash information as the main reporting elements. Budget data are in the core of the accounting system and constitute the overriding objective of financial reporting. The bases of accounting are adopted in accordance with these objectives. The basis normally used by administrations is a modified cash basis, where the measurement focus is on current financial resources and the changes therein.

The elements reported in financial statements are restricted to cash and near-cash items, as cash receipts plus short-term receivables; cash disbursements plus short-term payables; and cash and near-cash balances. When receivables and payables are recognised in financial statements, receipts and disbursements are anticipated in a period that should not be longer than three months.

Single-entry is the recording procedure used by the traditional reporting model, which focuses on compliance with budgetary, contractual and other legal requirements, including limits to expenditure. This system has not articulated financial statements, and its most important use refers to budgets and their execution. Supplemental data are reported on cash and near-cash balances, non-financial assets, non-budgetary financial items, among other items.

Legal compliance, budgetary control and other legal requirements are the real aims of the traditional accounting model for governments in Spain, very far from the search of information usefulness for economic and financial decision-making. In the new conceptual framework of governmental accounting, however, the relevance for decision-making has become one of the main objectives of governmental reporting, along with public accountability.

3. The reform of the budgetary system in the late 1970s and 1980s

In the late 1970s, during the political transition to democracy, an important reform was undertaken in the budgetary system, whose new characteristics and structure are still in force today. Some of the innovations introduced, such as program budgeting (Planning, Programming and Budgeting System, PPBS) had already been initiated in previous years, even though their objectives have never been clearly set up on a measurable basis. Therefore, this technique has been applied in a rather incomplete way, with more attention being paid to the form than substance, so rather ineffectively.

3.1. Principles

The budget is an annual statement of a financial nature. It shows the financial resources assigned to the public entities and the revenue forecast for the year. It is discussed and passed by the corresponding national, regional or local Parliaments. It is based on the following principles:

1. *unity*: all the revenue and expenditure must be covered in just one budget;

2. *universality*: revenues and appropriations for expenditure must be fully recorded in the budget and in the annual accounts, no offsetting between revenues and expenditures is allowed;

3. *budgetary specification*: the budget specifies the authorisation to incur specific expenditure;

4. *annuality*: the budget covers one financial year;

5. *clarity*: budgetary information must be understandable;

6. *disclosure*: the budget of public entities must be examined, discussed and passed by people's assemblies;

7. *economy, efficiency and effectiveness*: the necessary resources will be purchased at the lowest cost; the highest volume of goods and services is to be produced out of a specific amount of resources; and all the objectives stated for each policy are also to be accomplished;

8. *modified cash basis of accounting*: used in recording budgetary revenues and expenditures.

3.2. Classification

Budgetary expenses are classified according to three different criteria: who spends (organisational classification), what for (functional classification) and in what form (economic classification). Revenue should also be arranged according to the economic and organisational classifications. These classification criteria are also used in the regional and local levels of Spanish public administrations.

Within the economic classification, revenues and expenditures should be further classified in term of operating (or current), investment and financing items. This makes it easier to see the link between budgetary accounting and financial accounting, because the operating revenues and expenditures items correspond to financial accounting revenue and expenses, whereas budgetary revenues and expenditures related to investing and financing activities are connected with balance sheet accounts representing assets and liabilities of the same nature (fixed assets, financial investments, borrowing and lending operations...). The differences between the budgetary result and the economic income may be shown in a reconciliation note.

3.3. Stages in budget management

The basic steps in implementing the budget are described in Table 1. On the revenue side, revenues are forecasted in the initial budgets. After taking into account changes to the initial revenue forecasts, the updated revenue forecast is included in the final budget. As the government's revenue measures are included in laws and regulations, as economic activities and business transactions subject to revenue laws and regulations take place, the government's right to receive revenues is established. This right to receive is the basis for revenue recognition and the related receivables. Revenues are recognised simultaneously to receivables and when a concrete amounts can be measured for the rights, on the ground of legal dispositions. Upon collection, the receivables become cash. Receivables outstanding at year-end appear on the balance sheet.

The budgetary process establishes the amount of appropriations in the initial budget. Should there be changes in appropriations, these changes are reflected in the final appropriations available for use by the government. Decision-makers in the government authorise commitments in approximate amounts (global commitments): these authorisations result in the reservation of appropriations. When the authorised commitments are translated into legally binding contracts (*e.g.* for construction projects, contracts with suppliers and service companies), commitments are registered in the budget in definite amounts (specific commitments). However, the government's liabilities are not recognised until good and services have been received or rendered.[2] Thus the amount of unexpended appropriations is equal to the final appropriations minus the amount of liabilities. Payments are recorded in the system and then the amount of outstanding liabilities is therefore total recognised liabilities minus the payments made.

At the year of the fiscal year, unexpended appropriations may not be carried over to the next year, except for some commitments, if approved by the authorising officers. In the case of multi-year appropriations, the notes to the annual accounts disclose the total amount and the amount allocated to each year. Outstanding liabilities at the end of each year appear in the balance sheet.

Table 1. **Stages in budget implementation**

Revenue	**Expenditure**
a) Revenue forecast in initial budget b) Changes in revenue forecast c) Revenue forecast in final budget d) Receivables recognised e) Collection	a) Appropriations in initial budget b) Changes in appropriations c) Final appropriations **(1)** d) Global commitment (Authorisation) e) Specific commitment f) Recognition of the Liability **(2)** g) Payment **(3)** ***Appropriations unexpended* = (1) - (2)** ***Liabilities Outstanding for payment* = (2) - (3)**

The budgetary balance for the year is obtained by comparing the amount of revenue receivables and the amount of liabilities recognised by budget execution. While is no doubt desirable to reconcile the budgetary balance with results of operations under financial accounting rules, this step, however, is not required by the General Government Accounting Code.

4. The influence of business accounting during the 1980s

The basis of the present financial and budgetary accounting system has been laid down in the late 1970s and all through the 1980s. Hence, the current system of governmental accounting in Spain stems from the General Budgetary Law issued in 1977, which introduces the principles of budget preparation, execution and control and the basis for the development of a new accounting information system for the Spanish public sector.

In Spain, as in other Continental-European countries, the Accounting Code has been a paramount tool for the introduction and practical implementation of standards, both in business and governmental accounting.[3] In fact, an important step towards the modernisation of the economic and financial information presented by Spanish business enterprises was the enforcement of the 1973 Accounting Code under the strong influence of the 1957 French Code, which required financial statements to be presented according to accounting principles rather than just tax rules.

In this way, after the issue of the 1973 General Accounting Code for Business Enterprises, a General Accounting Code for Governmental Entities was adopted. In 1984 this code was approved, according to the Business Code framework and structure. Thus, this General Governmental Accounting Code is a conceptual core for the accounting information system of public entities in Spain.

Nevertheless, although the basic code was passed in 1984, the development of lower level administrative rules and detailed standards for particular entities and operations were not ready for specific applications until 1986. In that year, a Royal Decree introducing the Accounting and Budgetary Information System was issued, together with the most significant operative and more detailed accounting standards. Likewise, in that time, electronic data processing hardware and software for the implementation of the system at the state level were made available too.

Neither double-entry recording or the standards stated in the Accounting Code were effectively applied by local entities until 1992. In fact, in 1985 a Basic Law for Local Authorities set up a system for these entities, similar to that of the General Budgetary Law for Central Government. The basic principles of this law gave rise to more detailed budgetary and accounting standards, which allowed the implementation of the system in the early 1990s. The Accounting and Budgetary Information System for Local Governments was developed with similar principles and objectives to those set up by the central administration.

In addition, the Spanish regions (also known as *autonomous communities*) have issued their own governmental accounting standards, normally as a result of the adaptation of the General Governmental Code to specific characteristics of regional administrations. However, current accounting diversity prevents the system from providing an homogeneous information, suitable to be properly aggregated and compared.

For the purpose of management and cost accounting of public entities, basic models, as well as specific procedures and guidelines have been set up since 1987, especially for national agencies and public universities. However, these management accounting provisions are not compulsory, but voluntarily adopted by the entities.

5. The reforms during the 1990s and the new General Governmental Accounting Code

As in the field of business accounting, general principles for governmental accounting have been issued during the last years. Also, a new governmental accounting conceptual framework has been developed. As a starting point, a statement on "Governmental Accounting Principles" was issued in 1991 (see Intervención General de la Administración del Estado, 1991). This statement took into consideration the main national and international pronouncements on business accounting principles, including the then just passed 1990 Spanish General Accounting Code for Business Enterprises and the International Accounting Standards Committee Framework for Preparation and Presentation of Financial Statements.

Other specific Governmental Accounting Principles pronouncements were issued: on revenues and accounts receivables; expenses and liabilities; transfer payments and grants; public borrowing; non-financial fixed assets; and financial reporting by government. All these documents, along with the above-mentioned basic statement on Governmental Accounting Principles, constituted the conceptual background for a new General Governmental Accounting Code. Indeed, it was finally passed in 1994, and it has been in force from 1 January 1995. The new code is the general and basic Accounting Standards Framework for entities in national, regional and local public administrations.

The revised Governmental Accounting Code is an adaptation to public administrations features from the 1990 business code, as it was in the case of the 1983 Governmental Code in relation to the structure and standards contained in the 1973 Business Accounting Code. As in the 1990 revised Business Accounting Code, the new Governmental Code includes Governmental Accounting Principles; a detailed list (chart) of accounts and their recording standards and relationships; financial statements and notes; and valuation rules.

For public enterprises, accounting principles and standards do not differ from those of business enterprises, even though their activities are more strictly regulated by law, especially in relation to the duty of reporting to external audit institutions and special conditions for public contracts. For the other public entities,[4] important changes were introduced by the 1994 Code, moving definitively to be similar to business accounting principles, adapted in any case to the features of public entities, but preserving a single general conceptual framework, in use both for business and governmental accounting. Basic accounting principles and framework are thus common to business enterprises and public entities when applied to the preparation and presentation of financial statements. The general criterion for transaction recognition is full accruals. Nevertheless, in some cases, such as when recording fixed assets and capital grants, exceptions are applied to this general criterion. Therefore, it is generally stated that a modified accrual basis is used in financial accounting.

However, the general principles are adapted for budget transactions recognition, taking into account that the budget is a financial document and appropriations depend upon legal requirements. The most important implications when adapting general principles to the budget, are the use of a modified cash basis of accounting and the use of matching as a financial concept, instead of an economic one.

As a result of this adaptation there is a duality in the governmental accounting system: accrual accounting as a general basis, but using a modified cash system for budget reporting.

Financial statements to be presented by public entities are the balance sheet, income statement, budgetary revenue and expenditure account and notes to financial statements. The financial statements proper are balance sheet and income statement, with its notes; budgetary revenue and expenditure account and its notes are budgetary statements also to be presented by the entities.

The notes to the financial statements comment on and explain the information contained in the budgetary revenue and expenditure account, the balance sheet and the income statement. Information must be provided on the valuation criteria and the accounting policies followed and applied to significant transactions and events, more disclosure and breakdowns of the items on the financial statements, and other additional information not provided on other statements and which is necessary to present the true and fair view of the entity. Specifically, the most relevant components of the notes to the financial statements of public entities, according the General Accounting Code, are the cash flow statement, information on accounting policies and criteria applied, budgetary revenues and expenditures, public tenders, guarantees and commitments with third parties, earmarked funds and public debt and investments.

Budgetary and financial accounting is developed simultaneously by the accounting information system. If some priority order is to be given at all, financial accounting should then come first. Thus, receivables and liabilities should be recorded in both budgetary accounting and financial accounting systems, which are the main link between the two areas of the accounting information system.

The link between financial and budgetary accounting should be done through a table of equivalencies between the budgetary concepts and the accounts included in the list (chart) of accounts of the Accounting Code, which should have been established beforehand, in such a way that the bookkeeping entries might be generated through an internal and automatic process. The reclassification of budgetary expenditure into operating and capital expenditure should make the process easier. Nevertheless, some adjustments are sometimes necessary, with a view to making an adequate imputation of operating expenditures to the economic (*i.e.* financial accounting) result, such as pre-paid interests, for example, operating expenditures that will be assigned to economic expenses in the next periods. On the other hand, some operating economic (*i.e.* financial accounting) expenses not entered in the budget, such as the accrued interest and depreciation must be introduced in the financial accounting through specific entries, apart from those made through the budget implementation process.

With regard to revenue, reclassification of budgetary items into operating revenue and revenue from capital operations, should make much easier the equivalencies between the budgetary concepts and the accounts comprised in the list (chart) of accounts.

6. Underlying causes and events for the changes

From the late 1970s to the mid-1990s, the main reforms on the Spanish accounting and budgeting system for public entities took place on the basis of the General Budgetary Law passed by the Parliament in 1977.

The following underlying causes and events for those changes must be highlighted:[5]

The framework of the public sector accounting reform is initially the **budget**. A gradual development and autonomy of financial accounting subsequently takes place. In the Spanish system, the final aim is to integrate the budgetary realm and the financial accounting as two interlinked subsystems in the same information system.

The Spanish innovation process can be considered comprehensive (Vela, 1996b: 55). The result is a change in legislation that has reformed the accounting and budgetary system very uniformly among the different accounting entities (especially at central and local levels, bearing in mind that at regional level, the degree of heterogeneity is higher).

Spain has developed a reform that has followed a clear top-down approach. This means that the accounting and budgetary models were first implemented at the central government level, and then extended to the lower levels of government (especially to the local level). This is the reason why in Spain the accounting system of municipalities, reformed in 1990 following the model defined by the Accounting Code, is very similar to the model of central government (Vela, 1996a).

With regard to budgeting and governmental accounting, the influence of social variables (societal culture, financial markets requirements or pressure groups' role) has not been significant, as a result of the scarce demand for accounting and budgeting information by organised user groups. Indeed, the influence of capital markets has been rather limited. Their influence has not had the same impact as in other countries, considering that at local level, for example, the issuance of bonds is not usual. Not even at regional level, attention had been paid to this issue until the 1990s. In fact, only budgetary information from central administration had captured the interest of users.

As opposed to other European Union countries, the stimuli (fiscal stress, public sector management reforms, international influences) for the public sector accounting reform did not stem from public entities' financial stress or from a tax burden increase, but from a "demonstration effect" of business accounting and Anglo-Saxon traditions (Montesinos and Vela, 1996; 2000). Notwithstanding, none of these stimuli had any impact on the budgetary realm. In fact, it was really the need to discipline public expenditure, as a guarantee of stable growth and inflation reduction, that push the change forward.

The importance of political variables (political culture, political system and political change and competition) was evident at the beginning of the reform process at the end of the 1970s. Nonetheless, this influence seems to get weaker in the early 1990s, yet it comes out in the last years of that decade further reinforced.

However, the most important factors in the reform process have been the administrative variables (administrative culture, organisational model and internal control, innovation and reform process). Hence, although the traditional administrative culture and the rigid relationship among civil servants could have had a negative effect on the implementation of reforms, the top-down approach of the process, managed by just one official standard-setting organisation allowed for the final success of the changes. The state official body responsible to issue governmental accounting and budgetary regulation is the Office of the Comptroller General (*Intervención General de la Administración del Estado,* IGAE), whose activity increased significantly since the 1977 General Budgeting Law was passed. This body sets up the accounting and budgetary standards for central and local governmental entities and has a very active role in order to co-ordinate the accounting standards used in the 17 Spanish regions.

The importance of the administrative variables is therefore highly significant for the accounting and budgeting change, even though it might have been even more important to the latter, since the most highly qualified experts in this realm were civil servants.

The international influences of doctrine come mainly from the theory and practice in the United States (regarding PPBS introduction) and France (with regard to budgetary management, Accounting Code and relationship with National Accounts).

No significant implementations barriers (size of entities, staff qualifications, legal system) can be identified in the Spanish case, at least at central and regional levels. Thus, the legal system cannot be considered a strong implementation barrier, even if bearing in mind that in Spain, accounting standards are set by the law.

Nevertheless, at the local level, the reduced size of the jurisdictions (a great number of small municipalities), the staff qualification (more legal than economic or managerial) and the lack of an adequate EDP software, have had a negative impact on the reform process that started as a consequence of the 1990 Specific Accounting Rules for Local Authorities.

7. Change during the late 1990s: the European Monetary Union

7.1. Influence of European Integration

In the second part of the 1990s, the alteration in the European Union Treaty, signed in Maastricht in 1992, required a change in focus in the budgetary and accounting realm in the countries aiming to belong to the European Monetary Union (EMU). Amongst the events, diverse problems and circumstances having an impact on this change of focus in the late 1990s and early 2000s, the following ones must be emphasised with regard to Spain:

The Maastricht Treaty imposes a stability scenario for the European Union, which substantially constricts the financial and budgetary behaviour of member countries. Stability criteria regarding public deficit and debt are set within this scenario: deficit should not be higher than 3% of GDP of a EMU country and debt should not amount to more than 60% of such GDP. Compliance with these requirements represents an important political variable to explain changes in public budgets and accounting, with a view to adapting the measurement focus to those used by the European Union to quantify and control public deficit and debt.

The settlement of EMU public finances reporting requirements could have deserved more political concern on governmental micro-economic accounting figures, yet the attention has been mainly focused on macro-economic accounts, because European convergence criteria are set up on the basis of National Accounts information on public deficit and indebtedness. In Spain, as in other EMU countries, attention must be paid to the convergence criteria: this was specially emphasised the years before1998, the date when EMU was created. Up to that date, “creative accounting” methods (such as the new methods for funding capital assets, the delay in budgetary expenditures recognition and the “public debt decentralisation”) were sometimes used to comply with convergence criteria.

The **administrative variables** are logically dependent upon the political orientation of government. However, it must be highlighted that there is a growing interest to consider international experiences in this realm and to promote collaboration with academics. In this sense, there is an increasing number of studies, reports, recommendations and seminars about the challenges and innovations that arise in public sector accounting and budgeting, such as the consolidation of financial statements and budgets of public administrations, the introduction of full accruals in budgeting, infrastructure accounting and the experiences in OECD Member countries.

The **stimuli** for reforms have a special impact on the budgetary scope, as a tool to facilitate control and expenditure rationalisation. The target now is to achieve a “zero deficit”, which seems to be an ambitious objective, rather an axiom for the European economies highly impressed by the United States’ success during the Clinton Administration.

The stability scenario means that in the lows of the economic cycle, expenditure must be restricted. This has a negative effect on the implementation of accounting and budgetary innovations, whose impact on management improvement is not considered to be immediate or substantial. In this sense, just after the 1994 General Governmental Accounting Code was passed, Spain entered an impasse with regard to the actual implementation of the changes due to the lack of resources available for this purpose. This has meant an **implementation barrier** to the real progress of reforms.

Even though still in an initial phase, a social interest for these reforms, especially in the budgetary realm, is beginning to grow. This interest is mainly focused on the achievement of a “zero deficit” target and is made evident by the increasing follow-up in the media. Nevertheless, the pressure of these social variables is rather non-existent with regard to public entities financial accounting.

7.2. New orientation

The features of the new orientation of Spanish reforms in the 21^{st} century can be easily pointed out, as follows:

- Media attention is focused on the budget, rather than on financial accounting, because the stress is put on deficit and debt control within the European environment.

- Information relevance moves towards macro-economic accounting data, based on the procedures and methodologies of the European System of National Accounts (ESA95). ESA95 is a new European System of National and Regional Accounts that is based on the following elements: full accruals, consolidated information from the public sector[6] and all the debt (long- and short-term debt) of the public sector. In fact, only the magnitudes obtained in accordance with ESA95 are taken into account in the legislation initiatives, now under preparation by the government. Precisely, it is stated that "budgetary stability is defined as the situation of equilibrium or surplus, computed in terms of financing capability, according to the definition provided in the ESA95".

- This lower interest in micro-economic accounting is reinforced by the total lack of support of European institutions to harmonise national accounting standards, as opposed to their interest to increase harmonisation in the private sector.[7]

- The interest to achieve a higher budgetary discipline and expenditure control leads to new legal dispositions to introduce limitations to the spending capability and debt of regions and local entities. Hence, a new "Act on Budgetary Stability" is under way, in order to achieve and maintain a budgetary equilibrium ("zero deficit" or surplus) with regard to the nation's public income and expenditure, considering all central, regional and local administrations.

- Reforms in micro-economic accounting depend upon the above-mentioned objectives, and are specially aimed at the rendering of accounts, with the introduction of consolidated financial and budgetary statements.

- The influence of IFAC international standards will no doubt play a significant role in this process. The trend we expect is that national standards will be progressively adapted to IFAC standards. Nevertheless, this does not seem to be the main objective of the authorities, as previously stated. However, professional and scientific organisations, with significant influence, are working on the development of proposals of Public Sector Standards in accordance with the IPSAS (IFAC's standards).[8]

Therefore, it should be emphasised that the Spanish financial accounting and budgetary system is nowadays more or less the same that was designed in the late 1970s and led to the 1994 General Governmental Accounting Code. No revolutionary or substantial changes are expected with regard to this model, apart from a progressive use of full accruals and consolidated accounting information, putting the stress in some data that is nowadays recorded and measured with a different methodology from the one considered in the National Accounts.

7.3. Concluding remarks

The previous sections of the paper have explained the main guidelines of the budgeting and financial accounting model of the public administration in Spain. This model was born in the late 1970s and is rounded up in the system finally established during the 1990s.

The most significant factors to push the change forward have been as follows: a favourable political approach, civil servants wholeheartedly working to successfully implement the reforms and the continuous point of reference of business accounting., Even though there is still a clear need to improve the financial statements that are now prepared, especially in the case of local administrations, the Spanish model seems rather advanced in comparison to others in its environment.

From the mid-1990s, the priorities and criteria to qualify for EMU entry, the budgetary constrictions and the underdevelopment of managerial culture in public administration have changed the focus of the process and reduced the speed of reforms. The interest is now moving towards National Accounts, and therefore, micro-economic aspects are rather overlooked. Nonetheless, this move towards aggregated information is also taking place in other European countries, so the international stimuli for micro-economic accounting harmonisation are reduced. However, this process implies a high support for full accrual accounting and budgeting, in the lines of the magnitudes used by National Accounts. This will undoubtedly lead to a significant push to adopt GAAP in public sector accounting and budgeting.

Last but not least, in Spain we use the accounting and budgeting model derived from the change of political regime in the late 1970s. The budgetary accounting is based in the modified cash basis of accounting, whereas the financial accounting is based on the modified accrual basis. Even though in the short-term the interest is moving towards National Accounts, the need to provide an effective financial management and rendering of accounts by public administrations will imply a further development and improvement of the initiated reforms. The next steps will be taken bearing in mind IFAC's standards, to introduce consolidation of accounts and to remove the last impediments of full accruals use in the public sector financial accounting and budgeting.

NOTES

1. The term “public administrations” is customarily used in Spain to refer to governmental units. The term “government” usually refer to the Executive authority, exercised by the majority political party or a coalition of political parties that constitutes a majority in Parliament.

2. The term “obligations” is similar to “liabilities” in the Spanish budgetary and accounting system. No “obligation” can be recognised either in budgetary or financial accounting if goods or services have not been received or rendered.

3. An Accounting Code (also known as Chart of Accounts or Accounting Plan) includes basic principles, a detailed list (chart) of accounts with their recording standards and relationships, models for financial statements and notes and valuation rules. In addition to the Accounting Code as the basic document, there are also further adaptations and developments of accounting standards.

4. As IFAC puts it, these other public entities are: *a)* administrative and service delivery units funded exclusively or predominantly by general government revenues; and *b)* government themselves, whether at a national, regional or local level (International Federation of Accountants, 1993, Ch. 1, Par. 14). In a similar way, a definition of government business enterprise can be found in International Federation of Accountants, 2000b, Par. 6 and 11. In addition, according to the new ESA95, in force since 1 January 1999, the borders for different sectors of the economy are established according to a market criterion. Therefore, if an entity’s purpose is to produce goods or services for the market and it sells its production in the market, it must be included in the corporations sector, whichever the owner is, public or private (see Jones, 2000).

5. In this analysis of the underlying causes and events for change, we follow the contingency model framework developed by professor Lüder (Lüder, 1992, 1994).

6. Public entities are excluded if their income from the market is higher than 50%, no matter what legal form they have.

7. EU authorities are concerned with business accounting harmonisation, as a pledge for financial markets transparency and capital free trade. However, they do not put into action any project to harmonise governmental accounting in Europe, neither are they willing to do so in the near future, as stability conditions are followed up using national accounting figures, adjusted according to the accrual basis (see Cordes, 1996; Jones and Lüder, 1996).

8. The Public Sector Commission of the Spanish Association for Accounting and Business Administration (*Asociación Española de Contabilidad y Administración de Empresas,* AECA), is now preparing a conceptual framework for public entities, mostly in the same lines as the Spanish Conceptual Framework for Business Accounting and the IPSAS.

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