Improving the allocation of public spending

Public spending plays a critical role in development. Through spending, governments preserve and promote national identity, supply infrastructure for development, influence both the course of economic growth and the distribution of its benefits, and provide social services to meet the basic needs of the population. Yet rapid growth in public spending unmatched by domestic revenue has led many developing countries into fiscal crisis, and in many cases spending has been ineffective in promoting growth and equity. Governments throughout the developing world face the need to trim expenditures and to improve their allocation. It is a formidable challenge. The technical and institutional problems involved in planning, budgeting, implementing, and monitoring expenditures are very great.

This chapter addresses three questions:
1. How do governments spend their resources?
2. How might governments best spend their resources?
3. What institutional and technical reforms might improve the allocation of public spending?

Although the quality of budget execution is also critical in determining the ultimate impact of public spending, this and other issues of public management and administration were the focus of World Development Report 1983 and are not dealt with in detail here.

Patterns and trends in government spending

How do governments spend their resources? This section looks at both longer term trends in central government spending and patterns of recent spending cutbacks in selected developing countries.

Long-term patterns and trends

Central government spending as a share of GDP grew substantially in many developing countries until 1982 but then tended to decline until a renewed rise in 1985 (see Figure 5.1). As noted in Chapter 2, government spending as a share of GDP is smaller on average in developing countries than in industrial ones, but the exclusion of transfer payments (which are controlled by government but do not represent direct public claims on GDP) eliminates that gap. Generalizations about government spending patterns in the developing countries need to be treated with caution because of the wide variation among countries even at similar levels of income and because of the lack of comprehensive data on the public sector.

The countries of the Middle East and North Africa have, on average, the largest central governments in the developing world. This reflects in part the relatively expansive view of the public sector’s role in countries such as Algeria, Egypt, Syria, and Tunisia and in part the region’s heavy military spending (see Box 5.1). Central governments are smallest in South Asia, but state governments are unusually prominent in India and Pakistan. Central governments are of intermediate size in East Asia, Latin America, and Sub-Saharan Africa, with Africa’s somewhat larger than those in the other two regions.
Figure 5.1 Central government spending as a share of GDP by region, 1975 to 1985

Percentage of GDP

35
30
25
20
15
10

Middle East and North Africa
Industrial countries
Sub-Saharan Africa
Developing countries
East Asia
Latin America and Caribbean
South Asia

Note: Figures represent group averages weighted by GDP. Because of the lack of comparable data, China, Japan, Nigeria, and several relatively small countries are excluded from the samples in this figure and in Figures 5.2 through 5.7. Sources: IMF, Government Finance Statistics, various years, and World Bank and IMF data.

Classifying expenditures is problematic (see Box 5.2), but Figures 5.2 through 5.5 present some broad comparisons of the allocation of central government spending in low-income, middle-income, and industrial countries. In 1980 capital spending accounted for 16 percent of total central government spending in low-income countries and 23 percent in middle-income countries, compared with only 6 percent in industrial countries. (The year 1980 was chosen because data were available for more countries for that year than in later years.) This contrast between developing and industrial countries partly reflects their different priorities. Governments tend to emphasize infrastructural investment in the early stages of development. Basic infrastructure—such as roads, water, electric power, and telecommunications—is essential for developing a national market and an industrial base. Furthermore, the demand for such infrastructure rises rapidly with income at low levels of per capita income and tapers off as incomes reach a middle range. Spending on social services and income transfers takes on added importance as incomes rise; it expands in composition, coverage, and quality in response to demand pressures. It also becomes increasingly influenced by demographic trends as social services take on the character of entitlements (see Box 5.3).

Box 5.1 Military spending

An estimated 6 percent of the world’s total public spending goes for military purposes: more than $900 billion in 1985 alone. Industrial countries spend by far the most in absolute and per capita terms (heavily weighted by the relatively high spending in the United States), while developing countries spend more on the military as a share of their GNP (see Box figure 5.1). Most of the growth in military spending in recent years, both absolutely and as a share of GNP, has occurred in industrial countries. (These data exclude the Soviet Union and Eastern Europe. Their total military spending is equivalent to that of the industrial countries; as a share of GNP it is significantly higher.)

On a regional basis, Latin America devotes the smallest share of its GNP—about 1.5 percent—to military spending. Military spending as a share of GNP is highest in the Middle East and North Africa, where it accounted for 11 to 14 percent between 1974 and 1985. Military spending is also relatively high in East Asia (more than 7 percent of GNP), mainly because of high spending in China. It is less than 4 percent of GNP in South Asia and Sub-Saharan Africa.

The data are not necessarily reliable, however. Governments often deliberately understate and conceal military spending. They may categorize military-related construction as public works, combine military pensions with civil service ones, or classify interest on military debt with other debt service. Or they may not account for military spending at all and pay for it with export earnings that are never repatriated or entered into official trade accounts. If a bias exists, it is likely to lean toward understatement rather than overstatement of total military expenditure.

The goals of military spending are noneconomic ones—primarily defense against external threat and internal instability. However, some have also justified military spending by claiming it can contribute to economic development. A controversial 1973 study by Emile Benoît found that higher spending was positively associated with economic growth. This and subsequent studies have argued that military spending can have positive spinoff effects, such as fostering technological innovation, training personnel who later move into civilian work, providing employment opportunities, building domestic institutions, stimulating a country’s tax effort, and promoting more intensive use of existing resources. Furthermore, military industries can be a focus of industrialization activities. Although
Although these data cover only central government spending, the addition of data for state and local government and for state-owned enterprises (SOEs) would probably only heighten the differences among country groups. SOEs are most prominent in developing countries, where they concentrate on infrastructure and other economic services and typically account for a large share of public investment. State and local governments are more prominent in industrial countries, where military spending in developing countries has traditionally been for personnel and imported weapons, in recent years several developing countries—including Argentina, Brazil, China, India, the Republic of Korea, and Pakistan—have developed arms export industries of their own. Brazil is now the world’s sixth largest arms exporter.

These positive effects appear to be more than offset by the long-term negative impact of military spending, however. Research in the past decade, although not conclusive, points to a negative relation between military expenditure and economic growth. The most basic criticism is the high opportunity cost of military spending, that is, the diversion of scarce resources from more productive civilian uses. As seen in Figure 5.4, low-income countries spend much more for military purposes than for social services. The true difference is likely to be much greater, because IMF data appear to understate military spending. Moreover, the military has typically been the sector most protected from spending cuts (see Figure 5.8). A 1982 study of sixty-nine developing countries indicated that growth of military spending during the 1950s and 1960s significantly reduced overall investment, agricultural production, and economic growth. Other studies have found negative relations between military spending and spending on social development (including education and health) and between military spending and savings. Critics of military spending have argued that the spinoff effects are overstated—for example, that the linkages with civilian industries are small or that the benefits of military training to the civilian economy are few in countries with professional armed forces. Moreover, defense spending often has a high import content. In developing countries as a whole, arms imports represent about 5 percent of total imports. Payment for such imports can add considerably to balance of payments problems and to the debt burden.

In sum, although the controversy over the relation between military spending and economic growth is by no means resolved, evidence increasingly points to high military spending as contributing to fiscal and debt crises, complicating stabilization and adjustment, and negatively affecting economic growth and development. Whatever benefits might arise from such spending must be carefully weighed against these heavy costs.
they are major providers of social services such as education.

Current government spending is divided among subsidies and transfers, wages, other goods and services, and interest. Subsidies and transfers comprise the largest category, accounting for more than 40 percent of current spending in developing countries. Interest is the smallest category, although its size has been growing rapidly in recent years, especially in the highly indebted countries (see Figure 5.6). Spending on wages and other goods and services is a larger share of government spending in developing—particularly middle-income—countries than in industrial countries. As a share of GDP, however, the difference is much smaller (see Figure 5.3). Similarly, central government interest payments command a greater share of the budget in low-income countries but as a share of GDP are higher in the industrial world. As discussed earlier, perhaps the most striking difference between the spending patterns of developing and industrial countries is the large share of total spending. To overcome this bias, some countries have altered the traditional split between current and capital spending and have distinguished instead between “developmental” and other spending. Under this distinction the developmental budget includes current expenditures that either constitute investment in human resources or enhance the productivity of physical investment. While perhaps avoiding the bias toward tangible assets, this variant introduces difficult definitional problems that can make the distinction in the two budgets seem quite arbitrary.

In addition to the problem of bias, an emphasis on the current balance alone may be misplaced. For macroeconomic stabilization the important variables are the overall budget balance and its means of financing. Furthermore, borrowing may need to be limited not only for stabilization but also because public investment may not always yield long-term returns as high as the cost of debt service. Low returns on the investment of borrowed capital have contributed significantly to the current international debt crisis.

Finally, the existence of two budgets is often institutionalized in two budget-making bodies. For example, in developing countries ministries of finance often have responsibility for current budgets, while ministries of planning are in charge of capital budgets. Lack of coordination between the two can lead to serious inefficiencies and biases in the allocation of overall spending.
Central government spending per capita was only $44 in low-income countries in 1984, compared with $298 in middle-income countries and $3,429 in industrial ones. The disparities are even more pronounced in the social sectors. The low-income countries spent only $1 per capita on education and health, against levels more than a hundred times greater in the industrial world, especially if state and local government spending are included. Different levels of spending do not translate fully into different levels of inputs, because wage rates are lower, and thus purchasing power higher, in developing countries. Nonetheless input (and thus presumably output) differences are clearly huge. Big increases in spending are not possible for these countries; they lack the resources. Their task is to use the few resources they have more efficiently.

Patterns of recent spending cutbacks

In the early 1980s many developing countries reduced the share of government spending in GDP as international banks curtailed their lending and recession squeezed domestic revenues. Which public sector activities were worst hit by the new austerity? Figure 5.8 shows the average reduction in real central government spending in fifteen (mainly highly indebted) countries during the early 1980s. Total real expenditure fell on average by 18.3 percent. Capital spending suffered a 35.3 percent decline, while current spending fell only 7.8 percent. This may reflect the greater flexibility of capital spending; it is easier to cancel or postpone a few large projects than to lay off government workers, reduce civil service pensions, or delay or renegotiate interest payments. Among categories of current spending, lower payments for goods and services and for subsidies were partially offset by sharply higher interest payments. Analyzed by sector, infrastructure spending—
much of it capital spending—suffered the deepest cut. Social spending fell by somewhat less, military spending by much less.

Although the pattern of cuts is clear, interpreting it is difficult. First, the data show the decline in total spending as deflated by a general GDP deflator—not necessarily the decline in the actual quantity of government activity. If prices in some sectors rose faster than in others, the decline in services rendered would have been greater than indicated. Second, prior spending levels were not necessarily optimal; certain cuts should have been made anyway. Many cases of spending reduction in fact followed periods of rapid spending expansion. Finally, each cut needs to be judged in the context of the country where it happened. If the private sector is active in certain sectors, greater private sector activity may readily offset reduced government spending. In many cases, however, domestic recession hit private sector activity at the same time that public spending was falling.

Detailed case studies confirm that in many countries public investment dropped dramatically during recent periods of austerity. In Mexico, for example, total public sector investment fell from almost 11 percent of GDP in 1982 to less than 6 percent in 1986. In the Philippines it declined from 8 percent of GDP in 1981 to less than 4 percent in 1985. In addition, the cut in public investment was often exacerbated by lower private investment. Gross private investment in the Philippines, for example, fell from 23 to less than 13 percent of GDP between 1981 and 1985. An even more extreme case is Argentina, where gross private investment plummeted from 14 percent of GDP in 1980 to less than 3 percent in 1985, and net private investment (after depreciation) was negative—in other words, the capital stock was shrinking. In cases such as these it is clear that a revival of efficient investment spending, both public and private, is needed.
Population trends affect spending in the social sectors. This is particularly true in industrial countries, where many social services in education, health, and social security are considered to be entitlements mandating universal coverage. The predominant demographic trend expected during the next forty years in these countries is the rapid growth of the elderly population, both in absolute terms and as a share of total population. This trend implies higher spending on pensions and health care, offset only partially by savings on education, unemployment insurance, and other social programs.

Demographic trends are very different in developing countries. Most of these countries experienced high birth rates and declining infant and child mortality in the 1960s and 1970s, and many are still experiencing these trends. The result is rapid growth in the population as a whole and particularly among the young. In some countries, such as Kenya and Rwanda, school-age populations will double by 2000 and put added pressure on spending for education.

The demand for additional public spending resulting from these demographic trends must confront the reality of severe resource constraints. Many developing countries have not achieved universal coverage in such areas as education, health, and social security, so coverage and quality—rather than spending—may unfortunately be the variables that must adjust when populations increase. If a country has set a goal of achieving a particular level of coverage, higher population growth will make that achievement more expensive. Cutting costs and improving efficiency in the near term and moderating population growth over the medium term are both critical to expanding the coverage and quality of social services in developing countries.

Fertility rates in some countries, such as China, Colombia, and the Republic of Korea, have declined significantly since the 1960s. Perhaps the most extreme example is China, where, as a result of the one-child policy, the school-age population will fall during the next fifty years not only as a proportion of the total population but in absolute size as well. The working-age population is projected to grow from 64 percent of the total population in 1980 to 68 percent in 2000, and then fall again to 65 percent in 2030. The elderly population is projected to grow from 4 percent in 1980 to 7 percent in 2000 and to 14 percent in 2030. Pressures for social spending will ease in the next decade as dependency ratios fall, and China can emphasize improving the quality of services and access to them. Only well into the next century will the dependency ratio increase from today’s levels, as current and future workers reach old age. Long-range planning is needed to adapt to the changing balance of needs of young and old generations.

The risks and challenges of austerity

In sum, the data point to a steadily increasing role for the public sector in the economies of most countries in the world until the early 1980s. Increasing demands on governments have not been met, however, with the flow of resources needed to fund their activities. Adjustment programs, often mandated by fiscal crises, have forced cutbacks in public spending in some developing countries in the 1980s. Public sector investment has been particularly prone to cutbacks. Spending on wages and on subsidies and transfers has been reduced less, while spending on interest has increased dramatically because of rising debt burdens. Such changes in spending patterns hold considerable risk. Although curbing overall expenditure growth may be necessary to maintain or restore fiscal stability, governments must be increasingly concerned about the allocation of spending among activities and the quality of each activity. These will determine the longer run effect of public spending on development goals.

**Box 5.3  Demographic trends and public spending**

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**Figure 5.6 Trends in central government interest payments, 1975 to 1985**

<table>
<thead>
<tr>
<th>Interest payments as a percentage of GDP</th>
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</thead>
<tbody>
<tr>
<td>8</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>2</td>
</tr>
</tbody>
</table>


*Note: Figures represent group averages weighted by GDP.*

*Source: IMF, Government Finance Statistics, various years.*
Priorities for public spending

Governments must set priorities if they are to control the total level of spending and allocate it efficiently. These priorities should be based on two considerations. The first is an appreciation of where government involvement is necessary and, conversely, where markets can be counted upon to provide the same output as well or better. The second is an understanding of how limited resources can be spent most efficiently and effectively in the areas in which public involvement is called for.

As discussed in Chapter 2, both economic theory and practical experience suggest that governments should concentrate their spending in certain areas where their participation is necessary for a well-functioning market, for economic growth, and for the alleviation of poverty. Decisions on public spending should be grounded in an understanding of these basic principles and in the recognition of the fact that spending is not costless. All funds have alternative uses, or opportunity costs (see Box 5.1), and governments create economic burdens in the process of raising revenues to finance spending (see Chapter 4). In addition the public provision of goods and services may affect market prices or behavior (such as an individual’s work effort or tendency to save or consume). It may thus have far-reaching effects beyond its direct benefits.

Unfortunately, many governments are not allocating their limited resources efficiently or effectively. Too much is being spent in the wrong areas, and too little is being left for the critical tasks that only governments can perform. Misallocation is occurring both within and between capital and current spending.

Public investment

Governments must plan their public investment programs by jointly considering both their overall priorities for the economy and the appropriate division of responsibility between public and private activities. Intersectoral priorities will depend on economic structure, natural resource endowment, and development strategy. No clear techniques exist to guide intersectoral choices, although identifying bottlenecks in an economy and comparing rates of return to different activities may provide some clues. Intersectoral spending allocations are inevitably based largely on intuitive judgments, recognizing the need for overall balance between sectors.

Within any sector the principles discussed above can help to guide public investment decisions. The general goal of public sector investment should be to complement and support—rather than compete with—market-determined activities. The priority areas of public sector involvement in education, health, urban services, and rural infrastructure are discussed in Chapter 6. Both primary education and preventive health care provide broad benefits to society in addition to those received by the direct beneficiaries and would tend to be undersupplied without government involvement. There is room for government involvement in higher edu-
cation and curative health care, but more of the costs of these services should be borne directly by the beneficiaries through user charges. In both urban and rural infrastructure, governments have an important role in road construction, water supply, electricity generation and distribution, and solid waste disposal. Less justification exists for public involvement in bus service and housing construction, which can be provided efficiently by private companies. Unfortunately, many governments are not observing these priorities (see Chapter 6).

The roles for government investment in agriculture and industry were discussed in the past two World Development Reports. Government investment in these sectors should concentrate on providing basic complementary infrastructure, including electricity, water, transport, communications, and flood control. Basic research is also an important area for government involvement. Public investment in direct production or marketing of agricultural or industrial products is rarely justified on economic grounds. The involvement of SOEs in these activities has been widespread, however, often for historical reasons. Although SOEs can be as dynamic and efficient as privately owned enterprises if they are run by competent, autonomous managers, often SOEs are sheltered from competition or are subjected to intrusive political interventions, the appointment of unqualified managers, or the expectation that they will meet a variety of often conflicting social objectives (see Chapter 8).

Although setting priorities for public investment is a first important step in using the government’s limited resources most effectively, an equally important concern is the quality of investment. Several characteristics of investment projects contribute to quality and are important determinants of success (see Box 5.4). The investment needs to be not only economically attractive, but also technically, administratively, and financially feasible. The objectives of the investment should be clearly stated and acceptable to the main parties concerned. Finally, the policy environment should be stable and predictable and should create incentives that encourage efficiency. Government officials and project managers respond to input and output prices, interest rates, and the international trade regime in selecting and implementing investments. If these signals are significantly out of line with true opportunity cost, investments are unlikely to promote long-term growth. In Sierra Leone, for example, government price controls on the output of SOEs have led to a squeeze on SOE profits and thus on investment and maintenance.

Capacity has not expanded enough to meet demand, and the quality of services has suffered. Furthermore, SOEs are being decapitalized and require large government subsidies in many cases. Sierra Leone is not unique. SOEs in many other countries face similar problems because of price controls. It is clear that the success of public investment is being seriously hampered by the skewed policy environments in those countries.

**Operation and maintenance of investment**

Part of current public spending on goods and services goes for the operation and maintenance (O&M) of capital investment and is critical for the

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**Figure 5.8 Real reduction in central government spending in fifteen countries, early 1980s**

(unequated average percentage change)

![Chart showing reduction in central government spending in fifteen countries, early 1980s](chart.png)

*Note: The countries include Argentina, Bolivia, Brazil, Costa Rica, Dominican Republic, Indonesia, Liberia, Mexico, Morocco, Paraguay, Senegal, Sri Lanka, Togo, Uruguay, and Venezuela. Source: Hicks 1988.*
developing countries have lost road infrastructure more cost-effective use of resources. For example, maintenance and maintenance. The latter is frequently the

deliverance exacts hidden costs several times the cost of traffic is extremely low, insufficient road maintenance costs constitute a large share (75 to 95 percent) of total road transport costs, except when the traffic is extremely low, insufficient road maintenance exacts hidden costs several times the cost of restoring road infrastructure. These hidden costs, borne primarily by road users, can become a heavy drag on economic growth.

Unfortunately, spending on O&M (particularly

success of such investment in promoting economic growth and development. Inadequate spending on operations (whether supplies or personnel costs) can lead to low levels of effectiveness in areas such as education and health and result in a poorly educated, less healthy population. In Zambia, for example, a 1975 evaluation of health clinics found large shortfalls in drugs and medical supplies, with some key drugs (such as chloroquine, penicillin, and oral rehydration salts) out of stock for up to seven months in some areas. Inadequate spending on maintenance can lead to rapid deterioration of physical capital. In Indonesia, for example, inadequate maintenance of irrigation facilities has led to breakdowns and inefficiency in water delivery. It has lowered the productive life of irrigation systems by up to 50 percent.

Often a choice must be made between investment and maintenance. The latter is frequently the more cost-effective use of resources. For example, developing countries have lost road infrastructure worth billions of dollars through insufficient maintenance. In eighty-five developing countries with a main road network of 1.8 million kilometers, a quarter of the paved roads and a third of the unpaved roads outside urban areas need to be rebuilt. The cost of restoring these deteriorated roads—estimated at $45 billion—is three to five times greater than the bill would have been for timely maintenance. Furthermore, the cost of operating vehicles on deteriorated paved roads can be 20 to 50 percent higher than the cost on roads in good condition. If the road is unpaved, this difference can be more than 100 percent. Because operating costs constitute a large share (75 to 95 percent) of total road transport costs, except when the traffic is extremely low, insufficient road maintenance exacts hidden costs several times the cost of restoring road infrastructure. These hidden costs, borne primarily by road users, can become a heavy drag on economic growth.

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The success of seven cotton projects in three West African countries illustrates the positive effect of good public sector investment and some of the characteristics that lead to success. These seven projects have led to dramatic increases in the yields, the area planted, and the number of growers in cotton during the past fifteen to twenty years and have resulted in major production gains (see Box table 5.4).

Several characteristics of the projects account for this success. First, the objectives were clear and had strong support from the government. These included the provision of farm inputs, credit, and extension support for cotton and food crops; assistance to the project authority; the construction of feeder roads and village wells; and the establishment of a seed multiplication system. Second, the technical packages were well adapted to local socioeconomic conditions and were adjusted periodically to new developments at the international, national, and farm levels. The cotton companies, which

<table>
<thead>
<tr>
<th>Country</th>
<th>Seedcotton production</th>
<th>Yields</th>
<th>Area</th>
<th>Number of growers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burkina Faso</td>
<td>700</td>
<td>240</td>
<td>280</td>
<td>230</td>
</tr>
<tr>
<td>Côte d'Ivoire</td>
<td>450</td>
<td>140</td>
<td>330</td>
<td>190</td>
</tr>
<tr>
<td>Togo</td>
<td>800</td>
<td>160</td>
<td>660</td>
<td>590</td>
</tr>
</tbody>
</table>

Box table 5.4 The positive effect of cotton projects in West Africa

Box 5.4 An example of successful investment: cotton projects in West Africa

The financial arrangements did entail government subsidies on input use, however, that were quite expensive. Since 1984 all three countries have eliminated or considerably reduced input subsidies while increasing producer prices, thus maintaining adequate differences between output and input prices to provide good incentives for farmers. The overall economic environment for the projects has deteriorated somewhat, however, because of drastically lower world market prices. Even successful rural development efforts are vulnerable to unfavorable external economic conditions.
spending on materials and supplies as opposed to personnel) is generally undervalued and underfunded in developing countries. It is undervalued because the benefits are often hard to measure precisely and may lack political visibility. The benefits of increased operational spending in education and health, for example, tend to be subtle ones relating to quality rather than quantity, once the bare minimum necessary to keep schools and clinics open has been allocated. The benefits of maintenance—particularly routine as opposed to periodic maintenance—are often not clearly visible at all. They consist merely of costs avoided in the relatively distant future. O&M is underfunded not only because it is undervalued, however, but also because other spending demands—interest, subsidies, civil service wages, investment projects, and so on—exert stronger pressure on decisionmakers or lead to more visible disruption if not met. Furthermore, bureaucratic incentives may provide few rewards for efficient O&M once funds have been allocated. This leads managers to spend more on administrative overheads than on the delivery of services or supplies. More attention must be given to O&M in budget allocation and execution, and incentives must be changed to make this spending effective.

Public pay and employment policies

Among the most important issues surrounding spending on general government administration, as well as wage-related spending on O&M, are those involving public pay and employment policies. These policies differ considerably among developing countries. In Sub-Saharan Africa, for example, not only has the growth of public employment differed markedly among countries (see Figure 5.9), but the salary structure—including differentials in wages between skilled and unskilled workers and between public and private sectors—has also varied greatly. Salary differentials between senior (undersecretary level) and unskilled civil servants are twenty-five to one in Malawi but only seven to one in Zambia. The ratio of an unskilled civil servant salary to per capita GNP is greater than four in Liberia but less than one in Sudan and between one and two in Malawi, Sierra Leone, and Zambia. One consistent pattern among African countries and several other developing countries around the world is the decline from the mid-1970s to the mid-1980s both in real compensation levels—whether cash or fringe benefits—and in pay differentials between skilled and unskilled workers. Extreme cases include Ghana and Uganda, where real basic starting salaries had fallen to below subsistence level by 1983, and Sudan, where these salaries fell by four-fifths between 1970 and 1983.

Public pay and employment policies not only have important implications for the total level of public spending, but they also affect the development effort in other ways. First, employment and wage policies help to determine the mix of inputs going into the production of public goods. If the wage bill is too large and other expenditure categories are relatively underfunded, too much labor will be employed relative to nonlabor inputs. Com-
Box 5.5  Controlling the wage bill of the public sector

Many countries recognize that government pay and employment policies need reform, and some have taken steps in that direction. The following list describes some avenues for reform; the first five address employment and the last two the wage structure.

Civil service censuses and the elimination of "ghosts"

The most blatant abuse of government employment policy is the so-called "ghost" or "phantom" worker—somebody who receives government wages but either does not exist or is not employed in the position for which the payment is made. To isolate and delete "ghost" workers from the payroll often requires a civil service census that matches payroll data with budgeted and actual employment. Ghana and Zambia have carried out such censuses. Efforts to eliminate "ghosts" in the Central African Republic and Guinea identified 1,300 and 7,000 "ghost" workers, respectively, equivalent in both cases to roughly 7 percent of civil service employment. Once "ghosts" are eliminated, it is important to establish payroll mechanisms that prevent them from materializing again.

Elimination of vacancies and temporary positions

Audits of government employment in The Gambia led to the dismissal of 2,625 temporary and daily wage employees and 764 permanent employees and the elimination of 848 out of 10,700 civil service posts. Jamaica has also dismissed temporary workers. The significance of reducing expenditures on temporary labor should not be overlooked. In Zambia, for example, temporary workers account for roughly one-fifth of total government expenditure on wages. Such workers are often easier and less expensive to release than permanent staff, because they possess fewer legal claims.

Freezes on recruitment and suspension of employment guarantees

Employment can be reduced over time by freezing general recruitment, with some limited provision to replace essential staff. Retirements and other attrition will then reduce total employment. Costa Rica froze public sector employment for three years beginning in 1984. The Central African Republic limited recruitment with a rule permitting the hiring of one functionary for every three dismissed. This proved expensive because a higher level person was commonly recruited when three lower level ones were fired. Recruitment was subsequently limited to a ratio of one franc of hiring for every three francs of saving.

Suspending "employer-of-last-resort" practices can also reduce government hiring. Sudan abolished its employment guarantees for secondary school graduates during the 1970s. In general such guarantees are becoming less common, except perhaps for teacher colleges.

Automatic and voluntary retirement

Costa Rica and Senegal have imposed automatic retirement upon reaching retirement age or requisite years of service. Guinea is offering voluntary retirement.

plaints of teachers without textbooks, public health workers without vaccines, and agricultural extension workers without fuel for their vehicles are manifestations of this problem; the crowding out of investment by an excessive wage bill is another indicator. Alternatively, the combination of labor skills may be inefficient; corridors full of idle messengers outside the offices of overworked senior administrators point to this. Public employment programs initiated in part to combat unemployment, combined with the political difficulty of dismissing civil servants, appear to have led in many developing countries to an excess of workers compared with the availability of nonlabor inputs and to an excess of unskilled workers relative to skilled ones.

Second, civil service compensation creates incentives that affect performance. Rapid erosion in real compensation can reduce work effort (if employment is considered secure), because workers will turn to other activities—such as moonlighting, petty corruption, and the pursuit of nongovernment work during official working hours—to supplement their declining salaries. Maintaining staff morale and honest, efficient government under such conditions is difficult. Furthermore, while wage costs may decline, if services decline more than proportionally, the unit costs of government goods and services will rise.

Wage differentials between grades are important too. The severe wage compression that is occurring in many countries not only diminishes the incentive to work hard, but it also encourages better qualified staff to leave and lesser qualified staff to stay. Most efforts to reduce the public sector wage bill, although important in helping to achieve fiscal balance, have overlooked the critical importance of wage differentials (see Box 5.5).
While reducing the total workforce, such schemes provide governments with little control over who actually leaves public service, and governments risk losing staff they would prefer to retain. In addition, voluntary retirement schemes may require expensive inducement mechanisms, such as severance pay, to be effective.

**Dismissal of workers**

The most difficult form of retrenchment politically is outright dismissal of redundant or (even more difficult) incompetent workers. Severance pay for redundant workers can ease the transition. However, only those workers with a legitimate claim to public employment as an acquired right, rather than a recent windfall, should be eligible for severance pay. A public education program can ease the political costs of a dismissal program. In Guinea, French technical assistance financed an information campaign that publicized and explained the government’s retrenchment plan, and apparently increased the public’s acceptance of the austerity measure.

**Wage cuts, caps, and freezes**

The most common form of salary action is an across-the-board wage freeze. In 1982 Togo imposed a 5 percent cut in wages, referred to as the “solidarity tax,” and a multiyear freeze on salaries. These policies led to virtually zero growth in the wage bill from 1983 to 1986. Nigeria also froze its salary structure until recently. In addition it reduced fringe benefits, lowered transport allowances, cut cash leave grants in half, and eliminated subsidized lunches.

Wage freezes may relieve budget pressures only temporarily if governments acquiesce to built-up wage demands when the freeze is lifted. Furthermore, because freezes are applied to the salary structure and not to individual compensation, promotions may offset intended budgetary savings. A 7 percent increase in the real wage bill followed a wage and employment freeze in 1980 in Senegal.

**Wage differentials**

Salary reforms to improve the pay of senior staff are especially difficult to implement despite the clear need for them in many cases. Budgetary constraints and political pressures are significant barriers. Nonetheless, improving the overall performance of government may require such reforms. After sustained periods of wage compression both Ghana and Sri Lanka have increased the differentials in their salary structure. From 1984 to 1986 the ratio of top to bottom salaries in Sri Lanka increased from about 4:1 to about 12:1.

Creating supergrades for upper management, like the senior executive service in the United States, is one way to offer higher compensation to senior government officials. Ghana has seconded staff to several important government posts from more remunerative positions in SOEs or the private sector. Such secondment is currently eligible for financing through a World Bank technical assistance credit.

**Subsidies**

Subsidies fall into two main types. The first, which may include export or credit subsidies, is designed to encourage the private sector to undertake activities that generate external benefits. Subsidies of this type are intended to promote growth through more efficient allocation of resources. The second, which includes food or housing subsidies and subsidies to SOEs to support government-imposed price controls, is intended mainly to provide income support. Some such subsidies—those for food, health, or education, for example—can also be justified because of their social benefits.

Although subsidies can contribute to efficiency, the relief of poverty, and growth, their benefits must be carefully weighed against their costs—which can be very substantial. If a government’s revenue-raising capacity is severely constrained by administrative limitations, as is true in many developing countries, using scarce revenues to subsidize private activities will mean that fewer resources are available for other uses. The investments or O&M spending forgone must be seen as a major cost of subsidies in such cases. If a government’s revenue-raising capacity is not so limited—as in more advanced countries—a major cost of subsidies is the burden incurred in raising the revenue to finance them (see Chapter 4).

Still further costs of subsidies arise from the changes in private behavior they induce. Credit subsidies designed to spur investment, for example, cheapen capital relative to labor and can lead to excessive capital-labor ratios in production and thus exacerbate unemployment. In Thailand credit subsidies to agriculture in the late 1970s encouraged excessive mechanization and have since been scaled back. Similarly, subsidies on certain forms
Box 5.6 How agricultural subsidies affect the environment

Countries generally subsidize agricultural inputs to promote agricultural growth. However, the subsidies can promote wasteful, careless, or excessive applications of these inputs and lead to significant environmental damage. For example, many countries—including Colombia, Ecuador, Egypt, Ghana, Honduras, and Indonesia—have heavily subsidized sales of agricultural pesticides to overcome farmers' misperception of risk in adopting an unfamiliar technology, or in some cases to offset implicit taxes on farm output. Such subsidies ignore the negative effects of pesticide use on human health, other species, and the resistance and future resurgence of the pest itself. In addition, heavy irrigation subsidies in developing countries have encouraged low-return investment and caused or aggravated flooding and salinization, exposure of the population to waterborne diseases, and productivity losses in fisheries. Subsidies to chemical fertilizers have depressed the use of organic manures essential to long-term soil productivity, discouraged investments in soil conservation, and increased chemical runoff into surface and groundwater. Economic analysis of these programs has rarely considered their environmental effects.

Environmentally costly subsidies also exist on the output side. Several Latin American countries have subsidized livestock production on large estates through a variety of tax incentives, low-interest loans, and other means. As a result ranchers have cleared millions of hectares of tropical forest despite rapid pasture deterioration, low carrying capacity, and long distance from markets. Such subsidies have made investments that are questionable on both economic and environmental grounds highly profitable to private entrepreneurs, only few of whom are poor smallholder farmers. Brazil has subsidized ranching investments so heavily in some parts of the country that, although they lose more than one-half the capital invested, they yield positive returns to the private investors as high as 250 percent of their equity input. As with input subsidies, fiscal policymakers have rarely considered the environmental cost of these production subsidies.

of energy or food can lead to overconsumption and waste, as well as to inefficient use of the subsidized product in unintended ways. The use of subsidized kerosene rather than unsubsidized diesel or fuel oil in industry and the use of subsidized bread as animal feed are two examples. Furthermore, in some cases subsidies can have harmful environmental side effects (see Box 5.6). Finally, the mere existence of subsidies can divert the private sector away from productive pursuits while it lobbies for a share of the subsidies.

Although the exact magnitude of the costs associated with subsidies is difficult to measure, in most cases costs are likely to rise faster than benefits as the subsidy scheme grows. Careful targeting of benefits to those most in need can go far in increasing the benefit-cost ratio of such a scheme (see Box 5.7).

Public spending to alleviate poverty

Experience has revealed that certain characteristics of subsidies and other spending intended to relieve poverty help determine whether resources reach the poor efficiently and effectively. Assuming a service is needed by the poor, the first important characteristic is the level or standard at which the service is delivered, as indicated by the unit cost of the service per beneficiary. Poor people cannot afford expensive services, and no developing country government can afford to provide expensive services to large numbers of people free of charge. Therefore, programs that offer basic low-cost services are most likely to be of greatest help to the poor. Furthermore, such schemes are in a sense self-targeting, because higher income groups often seek higher standards of service.

For example, spending on low-cost, broadly based primary education is more likely to reach the poor than spending on expensive primary education or on higher education. In São Paulo, Brazil, low-cost approaches to preschool childcare, which use existing community buildings and mothers as teaching assistants, can reach five times as many preschool children for a given budget as high-cost approaches, which use new buildings and only fully qualified primary teachers. Similarly, investment in basic health clinics is more likely to assist the poor than investment in fancier clinics or hospitals. The same is true for upgrading slums as opposed to building new housing or for providing water through standpipes as opposed to individual house connections. Food subsidies can also be targeted to the poor by choosing less expensive foods to subsidize. A study in Brazil in the early 1980s showed that subsidies on bread or milk
would benefit the relatively well-off more than the poor, while a subsidy on cassava flour, a cheap food consumed primarily by the poor, would be highly progressive.

A second factor affecting a program’s effect on the poor is location; the poorest tend to be concentrated in certain regions, in rural areas, and in urban slums. For example, subsidies—whether for food, health care, education, credit, or housing—are unlikely to reach the poorest segments of the population if they are available exclusively in urban areas. Unfortunately, isolation—the very characteristic that tends to exacerbate poverty—also heightens the administrative difficulty and cost of projects designed to reach the poor in rural areas.

An urban bias in public spending programs has often been alleged but is hard to prove. One reason is the difficulty of tracing the spatial impacts of particular spending programs. For example, a bus terminal or port facility located in a city may benefit primarily rural dwellers. Another reason is that investments in urban infrastructure, whether for safe water, electricity, health, or education, tend to involve lower unit costs than their rural counterparts and thus may be justified on efficiency grounds. Although rural development should never be neglected, neither should the demands of urbanization that inevitably accompany economic development and growth. The main issue is not so much the distribution of spending, but rather how it is financed. Avoiding subsidies to urban services through increased reliance on local taxes and user

**Box 5.7 An example of expenditure targeting: food subsidies in Mexico**

Until 1986 the Mexican government offered global subsidies on most staple foods. Most subsidies were administered by the state-owned National Basic Foods Company, CONASUPO, through one of two mechanisms: either by selling the products at reduced prices to processors (who themselves were subject to price controls on output) or by reimbursing processors directly for costs not covered by sales revenue. These subsidies rose substantially in the early 1980s as the government increased guaranteed producer prices to stimulate domestic production and held down consumer prices to avoid upward pressure on domestic wages. In 1983 the total cost to the government of these food subsidies alone exceeded 1 percent of GDP.

By the mid-1980s subsidies of this magnitude were no longer sustainable. Mexico faced high fiscal deficits, rapid inflation, a rising debt service burden, and declining access to international resources. As part of an effort to reduce the fiscal deficit, policymakers reduced global subsidies in 1985 and phased most of them out in 1986. This more than doubled the real prices of both tortillas and bread. By the end of 1986 the remaining subsidies administered by CONASUPO amounted to less than 0.2 percent of GDP.

Because of the precarious nutritional status of the poor in Mexico, where more than 30 percent of preschoolers suffer from malnutrition, the elimination of all food subsidies for the poor could cause great suffering and undermine support for the government’s austerity program. The government addressed this problem by beginning a program of food coupons for tortillas, while continuing its existing program of milk distribution in poor urban areas. CONASUPO had long operated special stores that sold staple foods at subsidized prices in poor rural areas. However, all of these efforts were underbudgeted and ineffectively monitored. The government, supported by an agricultural sector loan from the World Bank, has recently expanded the food coupon and milk programs by increasing the number of urban families covered. It is also strengthening supervision and monitoring to reduce diversion of the subsidies to nontarget populations. If targeted to the poorest 20 percent (16 million persons), a funding level of $250 million would be approximately sufficient to compensate them for the global subsidies that were eliminated.

Targeted subsidies are a more efficient use of resources than are global ones, but they face difficult administrative challenges in Mexico and elsewhere. The first challenge is minimizing leakage to nontarget populations. Three types of targeting are possible: by location, if the poor are concentrated geographically; by food, if certain foods are consumed primarily by the poor; and by individual income or income indicator. The last, although the most exact in defining the target population, is the most difficult to administer because of the individual screening required. The Mexican food coupon system is officially targeted by income level; coupons are available only to families with total income less than twice the legal minimum wage. But CONASUPO’s outlets are concentrated in lower income urban areas, thus implicitly also targeting by location.

The second challenge is reaching the poorest and most malnourished, who in Mexico, as in many developing countries, live in rural areas and have limited interaction with formal markets. The rural CONASUPO stores already offer low-priced staples in many poor areas. Special efforts will be needed to improve their operation without crowding out efficient private wholesalers and retailers.
A third characteristic that determines the effect of public spending on poverty is the program's ability to reach the informal sector. Government programs that touch only employees in the formal sector, such as social security and other public pension schemes, subsidized employee health insurance, or civil service housing assistance, are not likely to alleviate the worst conditions of poverty in developing countries.

Finally, the effect of public spending on poverty can be increased through an explicit focus on employment and poverty alleviation in project design. Labor-intensive rural works programs, such as rural road maintenance, can efficiently create many jobs for the poor. Attempts have been made in recent years to bring a poverty focus into rural development projects. Of 192 World Bank projects approved between 1974 and 1979, for example, the cost for each beneficiary family was $1,104 for the 112 targeted projects, as compared with almost $1,400 for the 80 untargeted ones. Targeted projects could therefore reach more families for equal cost. The rates of return on poverty-oriented projects were not significantly different from those of the untargeted ones, which suggests that efficiency and equity can be compatible goals.

An agricultural project just beginning in Bangladesh provides a good example of appropriate public investment well designed to reach the poor. The project will finance basic complementary infrastructure, in particular new construction and rehabilitation of flood-control, drainage, and irrigation schemes. In addition to reducing crop losses and boosting yields by about 160,000 metric tons a year, it will generate employment equivalent to almost 5 million days of work. The project is expected to benefit more than 200,000 poor rural families, many of them landless laborers and sharecroppers.

Emerging lessons

Several lessons emerge from the above discussion. First, public investment should in general be complementary to, rather than directly competitive with, private investment. Second, public investment planners should concentrate on all aspects of project design. Projects should be not only economically viable, but also technically, administratively, and financially feasible, and set in a policy environment that provides signals to encourage efficiency. Third, adequate funding for continued O&M must be provided for the life of an investment. Fourth, developing-country governments must put greater emphasis on attracting and motivating qualified staff. They cannot afford to be employers of last resort for the entire labor force. Finally, efficiency and equity are not necessarily incompatible goals. Government programs that provide low-cost services or subsidies that are rigorously limited in scope and targeted to those most in need can help alleviate poverty at reasonable cost while building the human skills so important to growth. Untargeted subsidies have generally proven to be too costly and inefficient to be justified, given the tight resource constraints now facing governments.

Three important tasks faced governments as they plan, budget, and implement public spending decisions: they must control the overall level of spending, set priorities for its allocation, and ensure quality within each spending category. The challenge of planning and budgeting public spending is the focus of the rest of the chapter.

Planning and budgeting public spending

The two primary tools typically used in controlling and allocating public spending are the medium-term plan and the annual budget. The medium-term plan promotes careful consideration of spending alternatives, facilitates the phasing of lumpy investments over several years, and provides some indication of the sustainability of proposed revenue and expenditure patterns over the medium term. The annual budget is the authoritative legal document for allocating resources. It is not the best vehicle for medium-term planning because its time horizon is short, it provides little scope for proposing and evaluating options, and it is typically prepared under significant time pressure.

The continuing need for fiscal planning

The practice of planning has varied immensely in developing countries during the past thirty years. On one end of the spectrum are countries, such as China and Hungary, which have attempted comprehensive central planning and direction of both public and private investment. On the other end are economies, such as Hong Kong, in which little or no emphasis has been placed on central planning and in which investments have been guided essentially by price signals arising from a relatively freely functioning market. Between these two ex-
tremes are countries (including India, the Republic of Korea, Malaysia, and Singapore) that have used planning actively to guide public spending and set a framework for private sector decisionmaking, and countries (including Indonesia, Thailand, and much of Sub-Saharan Africa) that have regularly prepared central plans but have used them primarily as general policy statements and often have only nominally adhered to them.

Comprehensive central planning for the economy as a whole has lost favor in both government and academic circles in recent years. Many countries, including China and Hungary, have put growing emphasis on market forces and individual incentives. In part this follows a change in the emphasis of development theory. Although economists once thought structural rigidities in developing countries were a major barrier to growth, emphasis is now placed more on the harm done by distortionary price signals. This reflects the growing belief that resources are more mobile than once thought and that producers and consumers in developing countries do respond readily to price signals. Previous theories called for direct government intervention in resource allocation, while the newer view stresses the primary importance of well-functioning markets and correct price signals.

A further reason for growing skepticism with comprehensive central planning is the widespread disappointment with its results in practice. Centralized decisionmaking has proved inflexible and inefficient and has resulted in a growing array of state institutions and large public projects, some of which remain costly burdens. Planning has suffered, particularly in the 1980s, as financial crises have forced many governments to resort to short-term crisis management, crowding out almost any attempts to take a medium-term view.

The move away from comprehensive economywide planning should not signal, however, a move away from all planning. A danger exists that the current economic crisis may obscure the virtues of a medium-term plan for the public budget. Another danger is that ideological stereotypes will block reform, with comprehensive economywide planning linked to interventionist approaches to development and lack of planning to noninterventionist, market approaches. That would be regrettable, because the case for better management of public expenditure is not an ideological one. Fiscal prudence is needed in both capitalist and socialist economies.

The goal of fiscal planning should be to forecast and program public spending over a three- to five-year period and to take into account both likely resource constraints and the linkages of such spending with the economy. A comprehensive medium-term expenditure plan to accomplish such a goal contains several components. First, it sets out a macroeconomic framework linking the growth of national income, savings, investment, and the balance of payments to public expenditure and revenue. Second, it projects current spending obligations on debt service, public administration, defense, the operation and maintenance of investment, and so on. Although few if any items of spending are completely inflexible, some types of current spending (such as debt service on existing debt, civil service pensions, and certain portions of spending on O&M) are less flexible than others. Third, it defines a multiyear phased public investment program, divided between high-priority projects and those with lower priority that will be undertaken only if resources are sufficient. Finally, it projects revenue from tax and nontax sources and resources needed from domestic and external borrowing and grants. Such a plan is formulated on an iterative basis under alternative assumptions concerning the tax system, the level of user charges, policies toward SOEs, and the macroeconomic environment. It thus helps to achieve consistency between expenditures and macroeconomic assumptions, and stresses the role of public spending as a policy instrument.

Although few countries have the capacity to formulate such a comprehensive medium-term plan, the concept is a useful prototype toward which to strive. Progress on individual components is possible in many cases, as illustrated in some of the country examples cited below.

Using budgets as policy instruments

The annual budget is usually the legal authority for public spending. It is ideally a one-year slice of a medium-term expenditure plan, although in practice this link between planning and budgeting has often been tenuous. The role and form of the budget process varies markedly among countries and depends in large part on tradition. While the exact process may vary, certain key characteristics are important if the budget is to be an effective policy instrument.

First, the budget should be comprehensive. It should include all spending of the central government, whether financed by general taxes, earmarked sources of revenue, borrowing, or grants. Major investment projects of subnational levels of
government and of SOEs should definitely be subject to central review and might also be included in the budget or a related document. Although these entities need autonomy in managing their day-to-day operations, the central government should retain the right of approval over significant new investments or new borrowings.

Such comprehensiveness is more the exception than the rule, even at the national level. Extra-budgetary accounts flourish in many countries, both developed and developing. Furthermore, the investments, and in some cases even the borrowing, of state and local governments or SOEs are often excluded from central review. Some countries are exceptions. Core ministries in Chile and Panama, for example, are able to exert effective budgetary and administrative control over all public sector expenditure, and Thailand has established adequate monitoring of all public sector borrowing.

An important reason for the existence of extra-budgetary accounts and the earmarking of revenues is the desire to avoid cumbersome and often highly politicized budgetary procedures in funding essential services. Such accounts may be inevitable in the short-run when budgetary processes are severely dilapidated. The longer term goal should be to improve these processes, however, and to consolidate revenues and expenditures into the budget.

Turkey has experienced rapid growth in the use of extra-budgetary funds; more than eighty are believed to exist, about a dozen of which are large and fully operational. They accounted in 1985 for about 20 percent of central government budget revenue (up from only 8 percent in 1983), or 3.5 percent of GNP. Financed primarily through earmarked levies, the funds are used for such diverse purposes as promoting exports and investment, funding high-priority public investments, subsidizing agricultural inputs such as fertilizer and livestock feed, and financing miscellaneous social programs. They were created both to avoid cumbersome budgetary and disbursement procedures and to ensure protection from general budget cutbacks. However, their independence has undermined overall budgetary control, put added pressure on those items of spending that are included in the budget, and exacerbated inefficiencies and inconsistencies in the allocation of public resources. The government of Turkey recently announced plans to place up to 30 percent of the revenue of these funds into the consolidated budget.

In addition to being comprehensive, meaningful links should exist between government objectives (as laid out in programs and projects) and traditional budget categories such as salaries, equipment, and supplies. Traditional line-item budgets, useful in tracking spending in a narrow accounting sense, cannot provide an adequate picture of the extent to which public objectives are being achieved.

Several countries, both developing and industrial, have reformed their budgeting procedures in the direction of "program" or "performance" budgeting. Such reforms not only reclassify the budget to reflect objectives and programs, but also attempt to monitor government performance by relating inputs to outcomes. They have proved hard to implement because of institutional and informational difficulties in programming and in measuring performance. The outcome has been mixed. For example, Sri Lanka attempted to introduce performance budgeting in 1969 but abandoned it after 1976. A more sustained effort has produced a working system in India, but it is cumbersome, and the detailed information it produces (more than 2,000 pages) is not well adapted to the needs of the legislature or ministries. Performance budgeting reforms in Malaysia have had a deep and lasting effect in only two or three ministries. Despite these problems, the efforts in all three cases have improved performance measurement and auditing, have broadened managerial attitudes, and have indirectly improved resource allocation. In sum, although the term "performance budgeting" has lost favor because of the difficulties of implementation, its elements—the categorization of spending by program, the emphasis on monitoring performance, and the view of the budget as a planning and policy instrument—remain central to better public budgeting.

Improving expenditure planning and budgeting

Few countries—developing or developed—engage in such thorough decisionmaking processes as those described above. In fact, planning and budgeting systems in many developing countries have deteriorated markedly in recent years because of heightened economic instability. Some of the more common problems—ineffective basic accounting, the lack of an economic framework, uncoordinated decisionmaking, uneconomic investment choices, and failure to consider the lifetime cost of projects, to plan for contingencies, or to anticipate the effects of inflation on the budget—are considered below.
Rehabilitating basic accounting. The correct and timely recording of expenditures as they occur is an integral part of proper fiscal control. Whether, and after what delay, government accounts appear, and their credibility when they do, are the most basic indicators of the health of a fiscal system. Some developing countries fail in this elementary requirement for fiscal control. Accounts are often so late or so unreliable that they cannot serve as the basis for rational public expenditure planning or monitoring. Their absence can jeopardize the discipline of the entire planning and budgeting regime.

The example of one West African country is illustrative. Although the basic accounting system used to work reasonably well, in recent years it has disintegrated. The data needed to prepare and evaluate budgetary requests are no longer available, and the discipline of the budget timetable has been lost. Managers at all levels either disregard requests for budget estimates for the next fiscal year or submit estimates far in excess of what is possible. They reason that the government cannot fail to allocate some resources to their activities, that whatever they might submit is unlikely to be reflected in the ultimate budget, and that the actual release of funds will not match the budget anyway. Yet unrealistic budget submissions in turn destroy confidence among those who receive them. All phases of the process lose credibility in a cycle of mutually reinforcing skepticism.

Rehabilitation of basic accounting functions is a prerequisite for improving public expenditure management in cases such as this. Improvements in recording spending as it occurs should receive top priority. Computerization of government payrolls can be one significant improvement. Simple and systematic monitoring of the investment program can be another. Recent efforts to improve monitoring of the investment program in several African countries, including Ghana and Uganda, have focused on preparing simple project profiles. The standardized profiles contain five components: a concise description of project content and objectives, an unambiguous identifying title and project number, an estimate of total investment costs, a proposed annual phasing of investment costs, and an estimate of recurrent costs arising from the project. If regularly prepared and updated, these simple standardized profiles can be very useful in tracking project spending.

Setting the economic framework. In addition to knowing what was spent in the past, an assessment and projection of the macroeconomic outlook for the coming three to five years is important in estimating available resources. Yet governments often lack either the skilled personnel to do such macroeconomic analysis or the institutional incentives that ensure such analysis is properly considered when plans and budgets are formulated. As a result revenue forecasts and spending estimates may not exist or, if they do exist, may have little basis in reality. In addition, without central guidance the spending ministries and SOEs may make different assumptions concerning macroeconomic variables such as expected inflation or exchange rates that lead to inconsistencies that resurface at later stages of the expenditure cycle. Building up both macroeconomic and sector-specific microeconomic skills should be a high priority.

Coordinating decisionmaking. Responsibility for planning and budgeting is often dispersed among several institutions without effective coordination. While the organizational structure will depend in large part on history and tradition, and while a variety of structures can work in practice, coordination is essential.

Perhaps the most obvious example of this problem is the tension that often exists between the ministries of finance and planning: a common institutional question is whether the two should be merged. There are many examples of mergers and almost as many of subsequent separations. A number of countries, including Kenya and Sierra Leone, have been through several rounds of this process. Only rarely is there a genuine fusion. More often a single minister simply presides over both institutions. An exception is Botswana, where the merger of the Finance and Planning Ministries was a genuine merger of roles.

The question of whether to have one ministry or two, or a budget office separate from both, is perhaps not of central importance—reconciling the two functions is. Short-term budgets need to reflect a well-considered, longer term perspective, and medium-term plans need the accountability and relevance provided by direct links with the budget. The medium-term expenditure planning process discussed earlier can provide the vital link between the two.

Unfortunately, few countries have managed to integrate the planning and budgeting functions well. For several reasons the plan is often disregarded as the budget is prepared. First, plans may not be sufficiently detailed to provide guidance in budgeting. Second, the budget process is often
rushed and subject to many short-term pressures, not allowing adequate time to consider plan input. Third, planners may have less influence than budgeters, because the budget is the authoritative legal document, while the plan does not typically have the force of law. Frequent organizational changes can also diminish the influence of planners. In Argentina, for example, the planning function has undergone five major organizational changes and several minor ones since 1973, which has undermined its credibility. Finally, traditional stereotypes have sometimes acted as a wedge. Budgeters are often depicted as being concerned with short-term expenditure control more than long-term development, while planners are depicted as being overly concerned with economic aggregates over which the government has little practical control.

Chile and Thailand are two countries that have tackled the integration of plans and budgets quite successfully. Thailand has accomplished this through procedural measures rather than organizational ones. No project can be included in the annual budget unless it is first fully appraised according to methods approved by the planning agency and then reviewed by that agency. Chile, in contrast, does not have a separate planning agency in the traditional sense. Both annual budgeting and medium-term planning are the responsibility of the Finance Ministry and are carried out simultaneously. ODEPLAN, the central project review agency, assists the Finance Ministry in long-term planning and must fully appraise each project before it can be included in the budget. In both countries the planning and budgeting agencies have traditionally been well staffed, fully supported by the political leadership, and respected for their competence and professionalism.

Problems of coordination can also exist between core ministries and spending agencies, whether sectoral ministries, subnational levels of government, or SOEs. As discussed further in Chapters 7 and 8, in all of these cases the goal is to maintain coordination and accountability without losing the benefits of decentralized decisionmaking. With regard to sectoral ministries, the role of the central ministries (finance or planning) should be to set binding overall expenditure ceilings and to establish guidelines reflecting national priorities for the allocation of total resources among broad categories of activities. For example, the ministry of education might be allocated 10 percent more than the previous year’s spending limit, but told to hold higher education spending constant while increasing expenditure on primary education. Within these guidelines (and probably with restrictions on overall recruitment), the ministry could determine the best allocation of resources within each activity, subject to normal central review. Only the spending agencies have the specialized knowledge to make detailed allocations of resources within a subsector.

As a corollary to this division of responsibilities, the spending agencies should not be allowed to submit spending requests in excess of target—and thus force the central ministries, who are in a worse position to judge priorities, to take the responsibility for cutting the sector budget. In 1979 the Canadian government took an innovative step to reinforce this division of responsibilities when it introduced the “envelope” system into its budgeting process. Before 1979 ministers could approve policy ideas without explicitly considering their fiscal implication. Under the envelope system each policy committee in the cabinet is given an expenditure limit (“resource envelope”) for which it is responsible and within which it must fit all spending in its policy area. Both intrasectoral allocation authority and fiscal responsibility are thus delegated downward to those in charge of spending. While developing countries may perceive a greater need for central direction of public investment than industrial ones, the insistence on “hard” budget constraints at all levels and the devolution of fiscal responsibility represented by the envelope system can strengthen budget control in all countries.

Coordination can also break down during implementation. In theory, spending agencies (sector ministries or SOEs) should generally be responsible for implementing a spending plan once decisions about allocation have been made through the plan and the budget. Central ministries should monitor expenditures to ensure that the allocated amounts are spent for the assigned purposes (within some range of flexibility) and to assess the effect of spending choices on development. However, central ministries often react to tight budget constraints, overprogrammed budgets, or simple mistrust of spending agencies by slowing the disbursment of funds or by erecting unnecessarily cumbersome procedures in areas such as procurement, land acquisition, or contractor eligibility. Often these are politically easier ways of controlling a budget than denying funding requests as plans and budgets are formulated. Such indirect forms of control slow the implementation of projects and restrict managerial flexibility in the sectoral ministries and the SOEs. They may be better than no control at all, but they have costly implications for
institutions in planning and budgeting: they affect the morale, the staffing, and the managerial capabilities of the implementing agencies. Governments should instead foster accountability (particularly in SOEs) by giving financial and managerial autonomy while implementing a system of performance evaluation (see Chapter 8).

Of course adverse events may force a government to cut spending below originally budgeted amounts. Ideally the ministry of finance should amend the original budget by negotiating new ceilings with individual agencies, but in the short run slowing disbursements may be the only feasible way to make the necessary cuts.

Choosing between investments. Decisionmakers typically face a staggering array of choices when designing or updating a public investment plan. First, they must choose between alternatives for new investment, including rough ideas to be further investigated as well as projects with designs already worked out in detail. In addition they must consider the stock of ongoing projects, some funded by foreign aid and others not.

Preparing and updating a public investment program should be seen as a matter of screening, in which projects are accepted on the condition that they meet satisfactory appraisal criteria at appropriate stages in their life cycle. Projects at early stages of development would receive a less detailed screening; firm proposals for new projects should be subject to full-scale economic analysis before construction begins (see Box 5.8). Ongoing projects should not be exempt from continued eco-

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**Box 5.8 The role of cost-benefit analysis in project selection**

Few public investment projects are selected on economic criteria alone. Other concerns, including national security or the political or personal interests of policymakers, often play a role. Economic analysis can, however, indicate the potential effect of proposed projects on growth or poverty alleviation and can help prevent costly mistakes.

The basic technique of economic appraisal is cost-benefit analysis. It consists of adding up all the benefits and costs of the project to society, discounting them to reflect the opportunity cost of the invested funds, and calculating the absolute amount of discounted net benefits expected from the project (the "net present value"). The discount rate should reflect either the preference society has for consumption today over consumption tomorrow, or the amount that could have been earned if the funds had been invested elsewhere, or (if they are different) some combination of both. Social costs and benefits are intended to represent not financial costs and benefits to any particular individual, but the true opportunity (or "shadow") cost of inputs and outputs (such as goods, labor, or foreign exchange) to an economy.

Techniques of cost-benefit analysis originated more than fifty years ago in the United States and have become increasingly sophisticated since then. Analysts have devised methods to take into account such considerations as the distribution of costs and benefits of a project among income groups or regions, the net contribution of the project to national savings, the riskiness of the project and its correlation with other risks in an economy, and the economic costs of raising the funds necessary to finance the project. At the same time, however, inherent difficulties remain in such fundamental tasks as measuring costs and benefits and choosing the appropriate discount rate. How does one measure, for example, the benefits of constructing a national monument, building a prison, helping to create a more educated or more healthy population, investing in agricultural research, or controlling population growth? For a large class of public expenditures in which benefits are difficult to measure, "cost effectiveness" analysis—that is, trying to minimize the costs of an agreed-upon output or to maximize such output with given cost—is often more useful than cost-benefit analysis. Cost-effectiveness techniques cannot be used to compare the economic returns on investment in different sectors or between returns of different activities within a sector (such as primary and university education). Even though intersectoral comparisons of rates of return are possible with cost-benefit analysis, however, such comparisons are usually too uncertain to do more than indicate which activities might usefully receive greater priority.

The most important consideration in individual project analysis is not which specific type of economic analysis is used, but that some attempts are made to bring rational, objective, and, to the extent possible, quantitative analysis into the decisionmaking process. Systematic attempts at objective project appraisal will not always prevent poor investments, but if given sufficient weight in the allocation process, they are likely to provide some defense against the largest and most costly investment mistakes. They can also help in choosing among various alternatives for the size, location, components, timing, or technology of a proposed project.
nomic scrutiny merely because costs have been incurred. Their economic rationale may disappear as conditions change.

Unfortunately, economic criteria are often neglected, partly because many core and spending ministries lack the capability to appraise projects thoroughly. In addition, other considerations may take precedence over economic return: the power of interest groups, tied financing, the desire for prestige projects, the unwillingness to forget sunk costs and stop bad projects, ministerial lobbying, corruption, or simple inertia. Requiring that a team (possibly a centralized one such as ODEPLAN in Chile) carry out a simple and consistent project appraisal for every major project (including those of SOEs and subnational levels of government)—and then adopting procedures that ensure the results receive attention—can help to avoid the most costly mistakes (see Box 5.9).

**CONSIDERING THE LIFETIME COSTS OF A PROJECT.**

One way spending agencies try to preserve or enlarge their claims on the central budget is to submit a funding request for only the first phase of a large project without specifying what later phases will cost. Because projects are difficult to cancel once begun, the best way to avoid ballooning costs is to require that no project begin without a full picture of projected future costs.

It is important to emphasize here that “costs” include not merely capital costs but all recurrent resources needed to complete and operate the project. Although this point is now widely appreciated, the recurrent cost implications of investment decisions are often understated or overlooked. The problem is partly procedural. Recurrent and development budgets are often drawn up by separate processes, even by different groups of people, with little or no account taken of

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**Box 5.9 Economic analysis makes a difference: Thailand’s Eastern Seaboard Development Program**

An example of the importance of economic analysis in designing an investment program is Thailand’s Eastern Seaboard Development Program. The Fifth Five-Year Plan (1982-86) selected the eastern seaboard region of Thailand as a major new center for industrial development. The region was one of the most rapidly growing in the country and had several advantages: proximity to Bangkok and to raw material and labor supplies; excellent road, port, and communications infrastructure; and direct access to natural gas. The plan proposed large investments in heavy and light industry both to contribute to employment and export growth and to shift economic activity from Bangkok. Total investment for the program was projected to be $4.5 billion (in constant 1981 prices).

The government initiated a major study in 1981 to assess the feasibility and economic implications of this program. It concluded that:

- The economic rate of return for the overall program would be 9.7 percent, which meant a negative net present value using a 12 percent discount rate; but selected components had returns as high as 50 percent.
- The effect on employment would be relatively small, and the program’s cost for each job created would be very high—more than ten times the average for new industrial investment in Thailand in 1981.
- The financing requirements would place significant burdens on the Thai financial system; the program would require about one-third of the average new equity capital generated annually in the country.
- The program would contribute significantly to the country’s international indebtedness; it would require loans equal to about 10 percent of total medium- and long-term disbursements to Thailand in 1981.
- The program would impose substantial burdens on public finances by absorbing 6.5 percent of total public investment during the plan period and by reducing total revenues by 5 to 10 percent because of declining trade taxes.
- The net foreign exchange savings from the program could be substantial because of import substitution in heavy industry.

The doubts raised by the study, together with the subsequent deterioration of Thailand’s fiscal position, prompted the government to adopt a cautious approach to the program’s implementation. It subjected major components, especially the large-scale industrial projects, to further in-depth evaluation, and scaled down the program significantly. Total investment during the 1980s will probably amount to only about one-half of that originally projected. All parts of the program continue to be subject to economic and financial analysis. Such analysis is clearly making a difference, not only in the way public spending is allocated, but also in its effect on economic growth and development.
the complementarities between the two. The problem can also be one of inadequate information. Country-specific norms, established through empirical investigation of ongoing projects, can be useful as a rough guide in forecasting recurrent costs.

Botswana's planning and budgeting system is exemplary in its attention to the recurrent cost implications of investment spending. In preparing the most recent (the sixth) National Development Plan (covering fiscal 1985–86 to 1990–91), each sector ministry was asked to list the programs that it needed to carry out its sector policies. The programs were presented in summary form with a brief description of each project, its purpose, and its cost in both capital and recurrent expenditures. The investment ceilings were then determined from the overall targeted growth of recurrent spending, itself reflecting ceilings for use of skilled employees. The historical relation between recurrent and capital spending was an additional guide. The system allowed investments in excess of the ceilings only if a ministry could demonstrate that such investments would require no further allocations from the recurrent budget.

Planning for contingencies. Because of their inability or unwillingness to make difficult decisions, planners and budgeters often overprogram and pay too little attention to priorities, resource constraints, or phasing. In addition unexpected shortfalls can make a well-programmed fiscal plan obsolete. In the squeeze caused by an overprogrammed budget, the tendency is to cut or delay all spending rather than to define priorities. As a result funding for many programs is likely to fall below the minimum effective level. For these reasons setting priorities and developing contingency plans for unexpected shortfalls should be a part of any planning or budgeting exercise. This can be accomplished in part by formulating a "core" investment program—a group of projects that should receive funding under all circumstances—together with a list of standby projects to be funded only when additional resources are available. The common practice of partially funding all or most projects should be abandoned.

Adjusting for inflation. Plans and budgets are often drawn up in constant prices. Forecasting inflation is technically difficult, especially during periods of economic instability. Moreover, providing explicitly for inflation is often regarded as a self-fulfilling prophecy. Yet inflation can play havoc with forecasts made in constant prices, especially if spending rises faster than revenue when inflation accelerates. This is likely to be true if, for example, government wages and transfer payments are fully indexed to inflation while taxes are not. If fiscal deficits are to be properly managed, inflation must be taken explicitly into account in planning and budgeting. Medium-term spending plans, although generally drawn up in constant prices, should consider the likely consequences of alternative inflation scenarios. Annual budgets should be formulated in current terms, with contingencies built in for unexpected price movements. The problem is not unique to developing countries. The British government recognized the need to consider inflation in its 1981 shift from the use of constant to current prices in medium-term expenditure planning. Under the previous system automatic adjustments were made to spending allocations in response to price movements, which led to constant upward pressure on total spending. Under the new system of "cash planning," in contrast, binding cash limits are imposed on departmental spending, which allows greater discipline in budgetary control.

Coordinating donor activities. Donors finance a large portion of the investment budget in many developing countries—up to 100 percent in parts of Sub-Saharan Africa. Their involvement has both good and bad effects on the allocation of spending.

On the positive side, in addition to providing concessional funds, some donors carry out relatively comprehensive economic evaluation and demand thorough recordkeeping. Their skills in economic analysis and in project appraisal and monitoring may be higher than those of the borrowers. They can influence not just the selection of individual projects, but borrowers' standards more generally (see Box 5.10). Furthermore, they help to educate governments, citizens, and the private sector in the industrialized world about the problems of development and the urgent need for continued international capital transfers.

Balanced against this, however, are potential drawbacks. First, donors can complicate policy-making. In many countries each sector ministry deals directly with donors. This can lead to duplicate efforts and, more important, can impede central control of the budget. Lack of a central viewpoint makes intersectoral tradeoffs difficult to judge and overall spending hard to contain. In the extreme an investment program may be no more
Box 5.10  The World Bank’s evolving role in public expenditure reviews

The World Bank has made a significant commitment in the past few years to carrying out extensive analyses of the public investment and public expenditure programs of its borrowers. Aside from studies incorporated directly into general country economic reports, more than thirty public investment reviews (PIRs) or public expenditure reviews (PERs) have been produced. These reviews provide recommendations to governments on the size and composition of their spending programs and on ways to strengthen local institutions to enhance the countries’ own abilities to design such programs.

A typical review begins by laying out a feasible macroeconomic framework, which usually includes projected borrowing requirements of both the central government and the public enterprises. It may present alternative macroeconomic scenarios to illustrate the favorable consequences of policy reform or the unfavorable consequences of excessive spending. PERs then consider the adequacy of operation and maintenance expenditure and the appropriateness of the level of wages, employment, transfers, and subsidies. Both PERs and PIRs recommend a core public investment program based on a review of priorities for eight to ten sectors, including agriculture, industry, energy, transport, telecommunications, housing, water, education, and health. They consider ongoing and newly proposed projects in light of the sector strategy, the appropriate role of the public sector, and specific project selection criteria. They also consider financing alternatives, including cost recovery.

The role of these World Bank reviews has expanded and evolved in recent years. Earlier reviews looked mainly at investment priorities; more recent reviews have looked more broadly at the economic and institutional dimensions of managing public expenditure. Increasingly PERs are also used to examine particular types of government expenditure. For example, current expenditure and public social expenditure are being reviewed for Senegal and Brazil, respectively, in 1988. Recommendations on spending priorities are frequently incorporated into structural adjustment lending—at either the sectoral or economywide level. The reviews are also often discussed at meetings of aid donors, where concessional loans and grants are sought, and as an element of conditionality in IMF adjustment lending.

This process of public expenditure review faces two challenges in the future. First, so far the reviews have been very costly. The growing experience of Bank staff in conducting such reviews and the accumulation of country-specific knowledge should help improve cost-effectiveness. Second, ultimately the country’s own policymakers and economic staff should carry out the reviews, preferably on a continuous basis. Without this latter goal no lasting contribution can be made to the country’s institutional development.

than a list of projects that donors choose to fund, without any centralized consideration of the economic merits of each project or the balance between them. Furthermore, donor representatives may be under pressure from their own organizations to lend and disburse, which may lead them to seek special treatment. This could include separating counterpart funds from the budget or exempting projects from the normal procedural checks.

In addition, donors sometimes place restrictions on project funding that can lead to greater cost, heighten domestic budgetary pressures, or reduce effectiveness. One example is the requirement that aid be tied to the purchase of goods and services from the donor country, even if the cost is higher than it would be under competitive bidding. Another is the common refusal of donors to fund current spending on O&M. This means that budgetary pressures mount later, because countries must provide not only matching capital funds but also continued recurrent funding. It also reinforces the underlying bias against spending on O&M.

Aside from the need for changes in some donor policies and practices, all of these problems can be tackled through better coordination of foreign aid by borrower governments. Donor projects and financing should be incorporated into the central budget, and donor projects should be subject to at least the same standards of central review as domestically financed ones. The willingness of donors to fund should not be the decisive factor in allocating resources to investment. Efforts at better coordination of aid have increased in recent years, but the difficulties are great.

Indonesia provides an example of effective aid coordination. Donor activities enter into the normal planning and budgeting process, so that spending priorities drive funding rather than vice versa. The Planning Ministry coordinates the total size of the aid program and major policy decisions relevant to it, while donors work with individual
spending ministries on detailed project objectives and design. Although constant interaction among individual donors, sector ministries, and core ministries occurs throughout the year, donor representatives and senior economic ministers meet annually as a group. At this meeting the parties review recent economic developments, the ministers brief participants on upcoming policy initiatives, and donors indicate the size and provisional allocation of their funding for the coming year. A spirit of cooperation pervades the process, primarily because all parties see the government as both responsible for coordinating aid and effective in carrying it out.

Box 5.11 The importance of process in budget reform: the Kenyan task force on budget issues for agriculture

The problem was familiar, the causes baffling: Kenya's overall agricultural program in the mid-1970s was performing poorly. Projects were stalled, disbursements lagging, and overall results disappointing. What was going wrong?

Some of the difficulties clearly resulted from weak technical packages, from distortional policies (such as credit or marketing systems), and from poor project management. But the budget process also emerged as a source of problems. Officials of the Ministry of Agriculture insisted that funds were insufficient because of arbitrary budget cuts and slow disbursements of authorized funds by the Ministry of Finance. Finance officials, however, argued that fault lay with the Ministry of Agriculture and its poor use of the resources it received. It was clear that sector plans were vague, and that the many projects on the books did not together form a coherent investment program. Too much was spent on recurrent costs, especially salaries, and on financial support of parastatal institutions. Mistrust and failure to coordinate decisionmaking characterized the planning, budgeting, implementation, and monitoring systems. The budgeting process was not well linked with either planning or with final budget allocations, and funds took months to reach spenders.

Attempts were made to redress the problems through studies, technical assistance, and incremental changes in procedures and institutions, but to no avail. The root causes were simply too complex and involved too many actors and basic government procedures to be susceptible to simple, one-shot solutions, especially where these rested primarily on outside assistance.

The government finally decided to focus first on the process of reform rather than on detailed solutions. A task force, composed of top officials from the Ministries of Agriculture and Finance, was established in 1981 for two years (later extended) to recommend and implement improvements in planning, budgeting, spending, accounting, and project management. The work program entailed four formal meetings a year, which were geared to the major phases of the resource management cycle: the plan (forward budget estimates), the budget estimates for the year, the release of funds, and the evaluation of annual results.

Meetings were well attended and well prepared. Papers prepared by Kenyan government staff and consultants (mostly from Kenyan institutions) set the substantive agenda, which was eventually expanded to include the broader effect of budget issues on the work of the Ministry of Agriculture. The meetings focused increasingly on specific issues. Practical proposals and results followed. The process was linked with, and reinforced throughout by, exercises supported by the World Bank, including a public expenditure review, an agricultural sector loan, other agricultural projects, and technical assistance.

The effort was considered a great success. It helped to spotlight budget issues, promoted changes, and led to steady and visible improvement in the resource management process. For example, disbursements sped up dramatically, with the time required for funds to reach a project manager in the field falling from seven months to three weeks. A much stronger, policy-oriented budget proposal was prepared, with priorities clearly defined, and the Ministry of Agriculture was able to defend its budget more successfully. A sound project management system was launched. Overall the Ministry of Agriculture developed better management tools and information systems, aided by the introduction of microcomputers. The overall quality of agricultural programs improved markedly during this period. After four years the Ministry of Finance decided to begin a similar reform process.

Several lessons emerged from this experience. First, the "process" approach is a precondition for success. The outcome in this case was not, and could not be, precisely specified in advance. The direct involvement of participants in forging solutions was critical. Second, the budget is central to the policy process and is a good vehicle for promoting institutional change. Government policy is reflected directly in how funds are spent and how effectively. Finally, change in this field is likely to be quite slow and incremental. One-shot efforts or complex blueprints for change are unlikely to succeed.
Directions for reform

The tasks of containing and allocating spending call for medium-term plans and shorter term budgets that set clear priorities and ceilings. But developing countries face shortages of skills and information, fragile political systems, and unstable macroeconomic conditions—exacerbating the difficulties that all governments face in these matters.

Although improvement is certainly possible, reforms in planning and budgeting will be slow and incremental, as Kenya’s budget reform suggests (see Box 5.11). Along with a continuing need for training to improve civil service skills, experience indicates some directions for reform. The starting point is basic accounting. Governments must develop ways to track spending in a timely and accurate way. The next step is routine economic analysis—as part of the planning process—of both the macroeconomic environment and proposed investments. The first should tell governments approximately how much they will have to spend; the second should prevent at least the most flagrant mistakes of investment selection, while alerting decisionmakers to the future capital and recurrent cost implications of their choices.

Another basic concern is the coordination of decisionmaking among planners, budgeters, spending agencies, and donors. Budgets cannot be properly controlled and directed without it. All of these decisionmakers have important roles to play. In turn, each should be directly responsible for operating within clear limits—that is, within "hard" rather than "soft" budget ceilings. Furthermore, such ceilings should be in the form of cash limits on spending to prevent inflation from eroding budgetary discipline. Priorities within these ceilings should be as explicit as possible (for example, through the specification of a core investment program) to permit a flexible, efficient response to unforeseen circumstances. Finally, once allocations have been made, they must be followed up by monitoring, with the proper incentives in place to ensure that implementation proceeds as intended. Chapter 8 returns to this issue. It shows that many governments are already trying to improve the incentives for efficient performance of SOEs through innovations such as performance contracts and an expanded role for market forces in public provision.