

## Budgetary Reforms in Transition Countries

### The role of capacity building



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# Preface

During the last decade countries in Central and Eastern Europe, the Baltic States, as well as the countries in South Eastern Europe and the Newly Independent States (the so called transition countries) have worked hard to achieve an effective and sustainable public finance system. A substantial number of books has been written on the importance of budgetary reform in this process. Recent Dutch public finance history has pointed out capacity building as an important factor supporting the implementation of budgetary reforms.

In recent years the Netherlands Ministry of Finance has been requested by transition countries to share our experiences on budgetary reforms implementation and to fulfil an advisory role in this respect. We consider this a great honour. These requests have led to various forms of cooperation, all of them creating many valuable learning moments on both sides.

Since there are analogies with the kind of budgetary reforms transition countries are facing these days, it appears that transition countries implementing their respective budgetary reforms could benefit from our experiences. Vice versa, we are very much interested in learning from capacity building experiences in transition countries.

So, “What role is played or can be played by capacity building in transition countries working on budgetary reforms?” has become the leading question for this study. Our primary focus directed towards obtaining knowledge that is applicable in practice, this study reports on the experiences of three transition countries namely Bulgaria, the Czech Republic and Latvia. Consequently, the authors were able to formulate some lessons learned from practice. The inquiries funding the conclusions as well as the writing were performed by ECORYS-NEI, an internationally operating consultancy firm of renown, which takes full responsibility for the contents of this study. We express our gratitude towards them, especially the author John Zevenbergen, for their efforts and the final result. The views expressed in this report are those of the authors and do not necessarily represent those of the Netherlands Ministry of Finance or policy of the Netherlands.

The main results of the study were presented at a two-day conference on budgetary reform in transition countries, which took place in The Hague on 10 and 11 November 2004. The conference ‘Budget reform in transition countries: sharing experiences’ was jointly organised by the OECD and the Netherlands Ministry of Finance.

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## Executive summary

### Area of the study

Budgetary reforms in transition countries have been driven by three major developments. First, the transition from central planning to a market economy has pressured countries to engage in fundamental restructuring of the budget system. The major challenge lies in transforming the budget process from an essentially pure accounting mechanism to a real fiscal management tool. Second, many transition countries already have or will in the nearby future join the European Union (EU). The prospects of accession to the EU and the corresponding adoption and implementation of the *acquis communautaire* have increasingly shaped monetary and fiscal policies in these transition countries. Further impetus to budgetary reform has come from lessons of OECD countries that have experienced better expenditure outcomes as a result of fiscal consolidation and improvements of resource allocation and public sector performance.

The process of budgetary reform in transition countries has centred around three generally accepted basic objectives for sound fiscal management:

- *To instill aggregate budget discipline:* refers to the effective control of budget totals, by setting ceilings on expenditures that are binding both at the aggregate level and on individual spending entities. An effective budget system is one that has disciplined budget totals that are the result of explicit and enforced decisions. Budget totals should not merely accommodate spending demands.
- *To facilitate strategic prioritization and the reallocation of expenditures:* Allocative efficiency is the capacity to establish priorities within the budget and to distribute resources on the basis of government priorities and programme effectiveness. It is concerned with shifting resources from old priorities to new ones in correspondence with government objectives and from less effective to more effective programmes.
- *To improve the performance of the public sector:* by encouraging operational efficiency in the use of budgeted resources. This refers to the capacity to implement programmes and deliver services at the lowest costs, i.e. achieve outputs at the lowest possible cost.

For successful and sustainable implementation of budgetary reforms, the institutions that play a key role in the budget process need to be strengthened. The reform not only requires different rules and procedures, but also a change of the behaviour of public officials and often the development of new skills. Therefore, capacity building is a crucial element for many aspects of budgetary reform in transition countries. Sufficient attention should be given to the knowledge and skills of civil servants in order to make the new rules, procedures and working methods also work in practice. Following the definition of UNDP, we define capacity building as “the process by which individuals, organizations, institutions and societies develop abilities (indi-

vidually and collectively) to perform functions, solve problems and set and achieve objectives”.

This study is based on the present literature with regard to budgetary reform in transition countries and capacity building as well as three field visits to the Czech Republic, Latvia and Bulgaria. It describes the experiences with capacity building in these countries and formulates lessons that can be learned from practice. The key questions of this study are:

- 1 What role has capacity building played in implementing the reforms in transition countries?
- 2 How can capacity building be organized in the most effective way to contribute to successful and sustainable implementation of budgetary reforms?

### **The role of capacity building in budgetary reform**

In the Czech Republic, Latvia and Bulgaria the emphasis of budgetary reform started with the first objective of public expenditure management: achieving aggregate fiscal discipline. The fiscal framework in Latvia has been strongly governed by its agreement with the IMF to maintain fiscal discipline. This objective has received strong political commitment from all governments irrespective its composition. As a result of Latvia’s restrictive fiscal policy, the government debt is very low and is even one of the lowest among the new EU member states. Bulgaria has reached fiscal discipline through the exceptional measure of a Currency Board Arrangement, which still serves as a strong safeguard. The CBA has been extremely useful and necessary to gain and maintain fiscal discipline in Bulgaria. The priority of budgetary reform in the Czech Republic is also on achieving aggregate fiscal discipline. Important measures need to be implemented in the pension and health care sectors to reduce the budget deficit. In order to meet the fiscal targets, they will be set in a binding medium term framework that will enforce the aggregate level of expenditures within a three year horizon.

Important areas for capacity building in the Czech Republic, Latvia and Bulgaria that have contributed to achieving and maintaining fiscal discipline include:

- *Macroeconomic and fiscal forecasting*: to have the budget based on realistic macroeconomic assumptions;
- *Treasury*: to control cash management during budget execution;
- *Financial control and internal audit*: to assure compliance with the budget;
- *External audit*: to have a well functioning independent Supreme Audit Office to critically assess government spending.

In the Czech Republic, Latvia and Bulgaria further improvements in the second and third objective of public expenditure management – allocative and operational efficiency – are needed. Capacity building is of crucial importance for improving allocative and operational efficiency of public expenditure in transition countries. An important area for reform in this

respect is the introduction of programme budgeting to improve the link between policy and budget. Programme budgeting could be defined as a (re)classification of expenditures according to policy areas and with reporting on results. Capacity building in this area is not limited to the staff of the Ministry of Finance, but also involves programme managers and financial staff of spending ministries that need to change their working methods and, even more important but also more difficult, adopt a different result oriented attitude towards public expenditure.

### **Organization of capacity building**

The second question of this study is how capacity building can be organized in the most effective way to contribute to successful and sustainable implementation of budgetary reforms, based on the experiences of the Czech Republic, Latvia and Bulgaria. To answer this question a distinction can be made between three levels of capacity building that are needed for improving budgetary management:

- commitment and leadership from the top management;
- capacity building at the organizational level;
- capacity building at the individual level.

First of all, capacity building requires strong commitment and leadership from the top management. For as far as budgetary reforms are concerned, the Ministry of Finance, and most specifically the budget department, should be the key agent of change, which is going to recognize the need for reform, design the reform, and monitor and implement the reform.

Second, capacity building requires reforms at the organizational level. At the organizational level the focus is on organizational structures, processes, resources and management styles that affect how individual talents and skills are used to accomplish particular tasks. One can look at the best organizational structure to perform new tasks and at the need for a reorganization to improve performance. Other relevant issues to look at include the responsibilities that are given to the various organizations at different levels and the instruments that managers have to perform their tasks successfully. Often, information systems need to be developed in order to provide the new information requirements. Another important factor for capacity building is the culture of organizations. There may be a need to change the organizational culture, for instance to create an open culture in which professionals are stimulated to discuss issues with their superiors and take initiatives themselves.

The third level of capacity building is the use of human resources. Capacity building at the individual level relates to the recruitment, training, utilization, and retention of managerial, professional, and technical talent that contribute to task performance at the organizational level. Individual capacities, such as the knowledge and skills to perform new functions, can be acquired through training. Training can be considered as necessary but not

sufficient for capacity building within government organizations. It is important that trained staff is also able to use their new knowledge and skills when they go back to their day-to-day work practice. New functions need to be created and competences need to be developed to determine the requirements for the new functions. What qualities should people have to perform successfully, given their new roles and responsibilities? How well can positions and responsibilities be matched with the skills people have and best use made of the talents within organizations? Attention should also be given to other elements of human resource management, such as recruitment of qualified staff, reward systems and career development opportunities in order to prevent good people leaving the organization.

In the Czech Republic, Latvia and Bulgaria capacity building activities have taken place at all three levels, although the emphasis that has been given on particular levels of capacity building has differed across countries as well as the approaches and methods that have been used.

### **Conclusion**

The first question of this study is of what role capacity building has played in implementing the reforms in transition countries. On the basis of the experiences in the Czech Republic, Latvia and Bulgaria, it can be concluded that capacity building is of crucial importance for achieving the three objectives of public expenditure management: aggregate fiscal discipline, allocative efficiency and operational efficiency. We have observed large variations in size, focus, approach and methods of capacity building activities, but our general impression is that they have been of enormous significance for the improvements in public expenditure management in the selected countries. Capacity building is relevant in all phases of the budget cycle: budget preparation, budget execution, accounting and reporting, and internal and external audit. Attention should not only be given to the Ministry of Finance, but also to other participants in the budget process, for instance strengthening the financial management capacity of line ministries, improve the abilities of the Supreme Audit Office to critically assess government spending and enable Members of Parliament to better understand and evaluate budgetary documents and financial reports.

The second question of this study is how capacity building can be organized in the most effective way to contribute to successful and sustainable implementation of budgetary reforms, based on the experiences of the Czech Republic, Latvia and Bulgaria. In order to address capacity constraints in budgetary management in transition countries, our main conclusion is that a comprehensive approach towards capacity building is needed. It is important that capacity building activities take place at all three levels: having commitment and leadership for budgetary reform from the top management, improving the capacity at the organizational level and improving the use of human resources at the individual level.

# 1 Introduction

Budgetary reforms are key to achieving good public expenditure outcomes, because they influence the wider institutional and organizational setting and the type of information necessary for making and implementing expenditure decisions. Reforms in budget practices and processes have a substantial impact on the incentives provided to spenders and controllers. They should change behaviour in ways that promote desired outcomes of the budget process, such as the implementation of budget rules and accountability for results. Although acknowledging the importance of reforms on the revenue side of the budget (tax policy and tax administration), the emphasis in this study is on the expenditure side.

Many transition countries have managed to take on the challenges of budgetary reform and turned them into viable solutions. But the timing and sequencing of reforms have varied across countries, as have the depth and comprehensiveness of the restructuring packages. In general, budget practices have been more advanced in Central and Eastern European Countries, the Baltic States and Turkey compared to the West Balkan countries and the Newly Independent States. The progress has usually been dependent upon the degree and endurance of political commitment, the wider institutional and organizational framework as well as the progress in incorporating some basic principles of governance (i.e. transparency and accountability).

## 1.1 Pressures for budgetary reform

Budgetary reforms in transition countries<sup>1</sup> have been driven by three major developments. First, the transition from central planning to a market economy has pressured countries to engage in fundamental restructuring of the budget system (see section 1.1.1). Overcoming the legacy of central planning is crucial to the modernization of public sector budgeting practices and fiscal management techniques, as well as for wider economic development. The major challenge lies in transforming the budget process from an essentially pure accounting mechanism during the communist era to a real fiscal management tool. Second, many transition countries have already joined or will

<sup>1</sup> Throughout the remainder of the document, transition countries will refer to the Central and Eastern European Countries, the Baltic States, as well as the countries in South Eastern Europe and the Newly Independent States.

in the nearby future join the European Union (EU). The prospects of accession to the EU and the corresponding adoption and implementation of the *acquis communautaire* have increasingly shaped monetary and fiscal policies in these transition countries (see section ). Further impetus to budgetary reform has come from lessons of OECD countries that have experienced better expenditure outcomes as a result of fiscal consolidation and improvements of resource allocation and public sector performance (see section ).

### 1.1.1 Transition from central planning to market economy

The need to overcome the legacy of central planning has posed the most important challenge for budgetary reforms in transition countries. All of them have undertaken far reaching efforts to overcome many of the inherent problems in budgetary practices under central planning. Reforms of budget management in these countries are best understood in the context of their historical origins. The most salient features of the central planning budgeting system common to most of the transition economies in the past, comprise:<sup>2</sup>

- *Subordinate role of budget formulation process*: The main purpose of the budget formulation process under central planning was to translate the government economic plan, which was often specified in terms of physical inputs and outputs, into public sector inputs and outputs in financial terms. Instead of the budget formulation process controlling the allocation of public resources, the government's overall economic plan controlled the fiscal planning process.
- *Centralization of fiscal policy*: Under central planning, the national budget often included the budgets of central government and those for regional and local governments. As such, the budget process involved not much more than the aggregation of resource requests of spending units and lower levels of government according to pre-established rules.
- *Pervasive use of budget norms*: In combination with the highly centralized control over the budget process, the use of detailed spending norms by spending units and lower level governments created extraordinary rigidities in the resource allocation process.
- *Reliance on banking system for budget control*: Budgetary institutions in most centrally planned economies had no well developed budget execution and budget control systems. Instead the official government banking system played a crucial role in the budget execution phase. Central banks and the state monopoly banking systems were in fact responsible for keeping public sector accounts and exercising control over budget execution.
- *Extra budgetary funds and activities*: served to finance auxiliary items or support activities conducted by spending units outside their main bud-

2 A. Schick (1998b), A Contemporary Approach to Public Expenditure Management, World Bank Institute; and J. Martinez-Varquez and J. Boex (2001), Budget and fiscal management in transitional economies, Journal of Public Budgeting, Accounting and Financial Management, Boca Raton, Vol. 13, Issue 3: 353-397.

getary scopes. As extra budgetary funds and quasi-fiscal activities<sup>3</sup> were not formally part of the public sector budget, central budget authorities were unable to detect and control these practices, severely undermining fiscal discipline as well as allocative efficiency.

- *Lack of an independent external audit function*: was common to the budget process under central planning. This has made it particularly difficult to develop effective supreme audit institutions in many transition countries.

### 1.1.2 Prospects of EU accession

In transition countries that have prospects of accession to the EU, adjustments in monetary and fiscal policies are under way to provide the economic and institutional environment to cope with the implementation of the *acquis communautaire*. Compliance with the *acquis* implies the definition of a common macroeconomic policy framework for all member states that facilitates the functioning of the European Monetary Union (EMU). During the pre-accession phase, the rules for fiscal and monetary policies are still relatively loose. Countries have to implement policy reforms that will help them to fulfil the Copenhagen criteria that were defined in 1993 by the European Council.<sup>4</sup> The rules become progressively more constraining with the adoption of the *acquis* after accession and even more when the remaining *acquis* for the introduction of the Euro is put in place.

EU accession will require high political commitment to fiscal discipline, but also shape governments' priorities in (re-) allocating public funds and the need for efficiency gains at the micro level of fiscal management. The particular challenge for fiscal policy in EU accession countries lies in finding the right balance between the burden of structural adjustment because of catching up with the economic development in EU Member States on the one hand and the adherence with the constraints on fiscal deficits and exchange rate stability on the other hand. Reforming fiscal policy and management contributes to finding this balance by facilitating improved overall public sector performance.

### 1.1.3 Lessons from OECD countries

Further impetus to budgetary reform in transition economies has come from OECD countries that have experienced better expenditure outcomes as a result of wider reforms of their public expenditure management systems. Budgetary developments in OECD countries have focused on strong fiscal consolidation and improving the resource allocation and performance of the public sector. Although the magnitude of budgetary problems and the comprehensiveness of reforms have differed across countries, approaches to

3 A detailed description of quasi-fiscal activities can be found in the IMF Manual on Fiscal Transparency (2001).

4 European Commission (2003), European Economy – Enlargement Papers, No. 19, November.

achieving these objectives have converged considerably over the past decade. Nearly all OECD countries have experienced problems with fiscal deficits and high debt levels and saw the need to achieve the “macro” objective of fiscal consolidation while seeking to improve “micro” performance of fiscal management. To improve fiscal discipline, various OECD countries have introduced (indicative) medium term expenditure frameworks in which the multi-annual financial consequences of present and new policies are made visible (top-down ceilings with bottom-up estimates). Moreover, governments often have committed themselves to fiscal rules in order to limit the freedom of politicians and to provide guidelines on how to respond to changing circumstances.

The latest reform initiatives in a substantial number of OECD countries, such as Australia, New Zealand, the UK and the Netherlands, increasingly aim to link budgets to policy objectives and performance by promoting managerial accountability.<sup>5</sup> However, if the basics of a budget system have not been built up, the move to performance oriented budgeting involves many risks. Therefore, transition countries should follow a logical sequence of steps and first give priority to control inputs (compliance) and establish external controls before focusing on managerial accountability for producing outputs (efficiency and effectiveness) and giving broader discretion to line ministries.

## 1.2 Focus of this study

For successful and sustainable implementation of budgetary reforms, the institutions that play a key role in the budget process need to be strengthened. The reform not only requires different rules and procedures, but also a change of the behaviour of public officials and often the development of new skills. Therefore, capacity building is a crucial element for many aspects of budgetary reform in transition countries. Sufficient attention should be given to the knowledge and skills of civil servants in order to make the new rules, procedures and working methods also work in practice.

The major focus of this study will be on the role of capacity building in implementing budgetary reforms: how to improve the performance of organizations and individuals within the budget system. The key questions of this study are:

- 1 What role has capacity building played in implementing the reforms in transition countries?

5 OECD (2003), *Budget Reform in OECD Member Countries: Common Trends*, OECD Journal on Budgeting, Vol. 2, Issue4: 7-26; and D. Shand (1998), *Budgetary Reforms in OECD Member Countries*, Journal of Public Budgeting, Accounting and Financial Management, Fort Lauderdale, Vol. 10, Issue 1: 63-89.

- 2 How can capacity building be organized in the most effective way to contribute to successful and sustainable implementation of budgetary reforms?

Based on the experiences of three transition countries, the lessons that can be learned from practice will be formulated. The three countries that have been selected for case study are: Bulgaria, Latvia and the Czech Republic. These countries represent three different geographical areas – the Balkan, the Baltic States and Central Europe – and, at the same time, show different phases of economic development and EU accession.

Capacity building is not an end in itself but a means towards achieving desirable outcomes in public expenditure management. Therefore, in chapter 2, a theoretical background is given on the main issues of budgetary reform. Attention is given to the content of budgetary reform in transition countries, based on the three basic objectives of public expenditure management: aggregate fiscal discipline, allocative efficiency and operational efficiency. It shows the major issues that play a role in achieving these objectives and describes the experiences that transition countries have had with regard to these issues. In chapter 3 the focus shifts from *what* needs to be done to *how* capacity building can contribute to achieving that. It presents the main results of three field visits to the Czech Republic, Latvia and Bulgaria. To learn from the practical experience with regard to capacity building, interviews have been held with key officials that are or have been involved in the process of budgetary reform in these countries. The complete reports of the case studies are presented in the annexes A, B and C. The main conclusions and lessons learned with regard to the role of capacity building in budgetary reform in transition countries are given in chapter 4.



## 2 Budgetary reforms in transition countries

Achieving a sustainable and effective public finance system requires not only designing the right *fiscal policy* to achieve specific government objectives, but also improving the *public finance management*: the rules, procedures and processes that provide the right incentives for achieving the fiscal policy objectives.

The process of reforming the formal and informal rules and incentives underpinning budget management and institutions in transition countries has centred around three generally accepted basic objectives for sound public expenditure management:

- *To instil aggregate fiscal discipline*: refers to the effective control of budget totals, by setting ceilings on expenditures that are binding both at the aggregate level and on individual spending entities. An effective budget system is one that has disciplined budget totals that are the result of explicit and enforced decisions. Budget totals should not merely accommodate spending demands.
- *To facilitate strategic prioritization and the reallocation of expenditures*: Allocative efficiency is the capacity to establish priorities within the budget and to distribute resources on the basis of government priorities and a programme's effectiveness. It is concerned with shifting resources from old priorities to new ones in correspondence with government objectives and from less effective to more effective programmes.
- *To improve the performance of the public sector*: by encouraging operational efficiency in the use of budgeted resources. This refers to the capacity to implement programmes and deliver services at the lowest costs, i.e. achieve outputs at the lowest possible cost.

All three objectives are firmly inter-related and any well balanced budgetary reform package needs to adequately take into account interactions and possible trade-offs. For example, the manner with which aggregate fiscal discipline is achieved may impede strategic prioritization and technical efficiency. Ad hoc expenditure cuts during the year create uncertainty about flows of resources to prioritized programmes and undermine the predictability necessary for technical efficiency. Conversely, weaknesses in operational efficiency (i.e. poor delivery of services) may obstruct the actual achievement of budgeted priorities. Sound financial accounting and auditing systems help to improve operational efficiency, but this is equally important for the tracking of whether actual expenditures are within aggregate limits.

In this study we focus on budgetary reform at the level of the central government. However, it is important to make sure that actions of local government do not negatively affect the achievement of any of the objectives of good expenditure management. Moreover, fiscal decentralization could provide opportunities for improving aggregate fiscal discipline, allocative efficiency and operational efficiency.

Important pre-conditions for achieving these objectives are the integrity, transparency and accountability of the budget. It is crucial that the budget is based on reliable information. A dynamic system of internal financial controls, including internal audit, should be in place to assure the integrity of information provided in the reports.<sup>6</sup> The year end financial reports need to be audited by an independent external auditor in accordance with generally accepted auditing practices. Audit reports should be directly sent to Parliament (not through the government) and be used to hold government accountable as well as to improve the regularity, efficiency and effectiveness of public spending. Attention should be given to the follow-up of the recommendations of the Audit Office. Budgets and financial reports should be made publicly available.

Sections through provide for each of the three objectives an overview of the general requirements for sound public expenditure management. Then, per objective a summary of the most important budgetary reforms in transition economies is presented. The selection of reform initiatives is by no means complete and should be understood as reflection of the most important changes that have taken place in these countries. In section 3.4 an overview is given on the baseline measures that need to receive priority in transition countries in order to achieve the three objectives of public expenditure management.

## 2.1 Aggregate fiscal discipline

Aggregate fiscal discipline is inherently linked to what is known as the “tragedy of the commons”. Different claimants on government spending, each with their different perspectives on how the budget should be allocated, view the budget as a common resource pool that can be used at little or no costs. Although it is in the collective interest of all users to ration the use of the common resource, it is in the individual interest of each user to take as much as he can get. Spending ministries demand a level of expenditure for their own programmes that may be rational from their individual point of view, but exceed the level that is optimal for society as a whole. For these reasons, constraints that effectively control the aggregate levels of total and sectoral spending over the medium term become important. An effective

6 OECD (2002), OECD Best Practices for Budget Transparency, OECD Journal on Budgeting, Vol. 1, No. 3

budget system is one that has disciplined budget totals, which are the result of explicit and enforced decisions instead of a system that merely accommodates spending demands.

### 2.1.1 How to achieve aggregate fiscal discipline?

Changes in budgetary institutions can help to mitigate the tragedy of the commons and establish and enforce aggregate fiscal discipline. The following are important features of such systems.<sup>7</sup>

- *Fiscal targets should be based on comprehensive budgets:* Budgetary reforms need to focus on the development of a consolidated budget, where all expenditure proposals are considered at the same time and within the same overall fiscal target. This includes the reduction of off-budget activities and the number of extra budgetary funds but also the fragmentation of the budget into different parts (i.e. the separation of current and capital expenditures). This allows for a better depiction of a country's fiscal deficit situation and makes associated risks more transparent. Comprehensiveness of the budget facilitates consistency in decisions, trade-offs between different alternatives and hence strategic prioritization among expenditures;
- *Fiscal targets should be achievable and be based on realistic and prudent economic assumptions:* Assumptions about economic variables such as interest rates, economic growth and inflation underlie the projections of government revenues and expenditures, and therefore the budget. Using realistic and prudent economic assumptions and taking sufficient fiscal action helps to ensure that budget goals are achieved and financial credibility is maintained. Building fiscal forecasting and analysis capacity is a vital component of budgetary reforms;
- *Fiscal targets should be set in a medium term framework that enforces all budget aggregates:* A medium term expenditure framework (MTEF) should function as the baseline for setting and enforcing all main budget aggregates (revenues, expenditures, deficits and debt), and for measuring the budgetary impact of policy changes. A MTEF is not only a top-down process (setting ceilings) but also a bottom-up process (preparing multi-year estimates). The government commits itself to the targets that it wants to achieve with regard to the deficit, debt, total expenditures and/or total revenues, not only for the budget year but also for the years that follow. With multi-annual expenditure caps, the caps for total expenditures cannot be changed in the annual budget process. It implies that the government will have to cut expenditures if they do not fit within the ceiling in any of these years. Decision making during the annual budget process needs to focus on changes in expenditure levels within and between sec-

7 R. Allen and D. Tommasi, *Managing Public Expenditure – A Reference Book for Transition Countries*, SIGMA, Paris; and A. Schick (1998), *A Contemporary Approach to Public Expenditure Management*, World Bank Institute; and J. Martinez-Varquez and J. Boex (2001), *Budget and fiscal management in transitional economies*, *Journal of Public Budgeting, Accounting and Financial Management*, Boca Raton, Vol. 13, Issue 3: 353-397.

tors without exceeding the total ceiling. The annual deficit is allowed to fluctuate, possibly under the provision that a critical ceiling is not exceeded;<sup>8</sup>

- *Fiscal targets need to be enforced:* The Ministry of Finance should be empowered to enforce the budget total. This could be done by the introduction of budgetary rules both at macro-level (e.g. not allowing a deficit of more than 3% of GDP) and at micro level (e.g. rules of budgetary discipline regarding compensation of overspending by line ministries). Setting appropriate fiscal constraints that reflect the commitment by political actors is important to guarantee support for their enforcement throughout the budget cycle.

## 2.1.2 Experiences of transition countries

In response to the severe macroeconomic imbalances during the early years of transition, most transition economies have undertaken enormous efforts to reduce the level of government spending and adjust its composition. Curtailling excessive fiscal deficits and enforcing aggregate fiscal discipline have been the top priority of transition countries in the framework of overall budgetary reforms. This emphasis reflects the need for policy makers for fundamental and quick actions in the light of huge macroeconomic imbalances and social hardships caused by the collapse of the central planning system at the beginning of the 1990s. Equally important in this context have been the strict requirements for fiscal consolidation by the international community, particularly the IMF and World Bank, and the European Commission for EU candidate states. As a result, governments in many transition countries have managed to achieve a reasonable level of macroeconomic stability and sustainable public deficits. A wide range of fiscal consolidation measures have been implemented in transition countries, which for example have aimed at promoting strict rule-based monetary arrangements, budget comprehensiveness, building capacity in fiscal forecasting and designing treasury functions.

Effective coordination of monetary and fiscal policy is key to achieving macroeconomic stability. Poor practices in either one-policy area can cause severe economic imbalances and endanger consolidation efforts in the other. A prime example in transition countries has been the susceptibility of many central banks to pressures from governments to finance undue public deficits. Monetary policy being subservient to fiscal policy has led to excessive government borrowing. As a result of the rapid growth of public spending relative to nominal income, inflation and interest rates on government debt often rose to enormous levels. Many governments started to promote central bank independence and the design of strict rule-based monetary arrange-

8 OECD (2004), Best Practice Guidelines – Off Budget and Tax Expenditures, 25th Annual Meeting of Senior Budget Officials, Madrid, 9-10 June.

ments, such as currency boards.<sup>9</sup> Currency boards have been a welcoming tool for many transition economies to force fiscal discipline upon the budget process, often with impressive economic results, both in terms of lowering inflation, reducing interest rates and fiscal deficits, and stabilizing expectations and economic credibility.

A frequent response by budget units in transition countries to the imposition of strict expenditure ceilings during reforms is to finance an increasing share of activities off-budget. Attempts to protect expenditure priorities from budget cuts and to concede to requests of powerful political lobbies are the chief reasons for such budget practices. Off-budgeting can lead to serious distortions in the budget and expenditure management framework. As the deficit problem is simply shifted off-budget, fiscal discipline is seriously undermined, both at budget preparation and execution stages. Most transition countries have made considerable progress in achieving greater comprehensiveness of the budget by reducing the number of extra budgetary funds and off-budget activities, and including them within the budget under the same fiscal target. Countries have further passed regulations that manage more tightly the creation and operation of extra budgetary funds. Reducing off-budget activities forms an important part of early reforms in budget practices as it helps to cement fiscal discipline, facilitate strategic prioritization and make fiscal risks more transparent.

Fiscal adjustment that aims at solely keeping expenditure levels in line with targeted fiscal deficits is insufficient to prevent fiscal instability in countries with large, unbudgeted contingent liabilities. Contingent liabilities may lead to an enormous and uncontrolled drain on future government expenditure and pose a threat to fiscal sustainability, if they are insufficiently accounted for.<sup>10</sup> Economic realities in transition economies confirm that fiscal deficits usually increase significantly once fiscal risks are fully included in the government budget. The attempts of transition countries to promote the identification, classification and understanding of fiscal risks facing the government and improving public accountability of politicians and civil servants are important reforms in this context. This can be achieved by internal and external control mechanisms. An independent Supreme Audit Office and complying with international accounting rules can pressure governments to monitor and disclose information on the underlying key assumptions of the budget estimates and the size and risks of contingent liabilities for the government's fiscal position. Also capacity building may be required to identify and assess fiscal risks and to develop sound fiscal risk management strategies.

9 C. Enoch and A.M. Gulde (1998), Are Currency Boards a Cure for All Monetary Problems?, International Monetary Fund, Finance & Development, Vol. 35, Issue 4.

10 R. Allen and D. Tommasi, Managing Public Expenditure – A Reference Book for Transition Countries, SIGMA, Paris.

Vital components of successful fiscal management reforms in transition countries have been efforts to build macroeconomic and fiscal forecasting and analysis capacity. These centred on the establishment of forecasting agencies that have the capacity to undertake realistic revenue forecasting and fiscal analysis (i.e. quantifying the impact of tax reforms on government revenue) and strategic medium term fiscal planning. Sound forecasting capacity of key economic assumptions underlying the budget reduces the risk of unexpected financing gaps and hence of endangering fiscal consolidation efforts. Economic assumptions must be prudent and disclosed openly, and preferably independently prepared. Adequate forecasting capacity serves as a safeguard against the use of unrealistic and over-optimistic economic growth and revenue forecasts. Credible multi-year targets help to increase the degree of realism in the expectations of line ministries, as attention will shift from claiming funding towards using available funding more efficiently and effectively.

Controlling spending in the aggregate is reinforced by fiscal discipline of spending units at the micro level. Overspending can only be restrained if the financial resources are efficiently managed. In the past, governments in many transition countries did not pay sufficient attention to issues related to efficient cash management. Budget execution procedures and the management of cash flows focussed on legal regularity and compliance, while daily cash needs were met by the central bank. Many transition countries have therefore started to build capacity throughout their budget execution process by designing treasury functions. The creation of a Treasury Single Account (TSA) at the central bank forms an essential part of an overall treasury system and has enabled transition economies to centralise cash management and ensure better overall cash control.<sup>11</sup> The progress in building advanced TSA has often taken much longer than expected, foremost due to the magnitude of resources required to implement such systems and to persuade authorities to undertake radical reforms. Implementing a government-wide information system that allows for and strictly defines the boundaries of access by the Ministry of Finance, the treasury department, the line ministries and other spending agencies imposes high demands on the quality of hardware and software of the overall accounting system.

## 2.2 Allocative efficiency

Allocative efficiency is the capacity to establish priorities within the budget and to distribute resources on the basis of government priorities and a programme's effectiveness. It is concerned with shifting resources from old priorities to new ones in correspondence with government objectives and from less effective to more effective programmes. Enforcing fiscal discipline

<sup>11</sup> Ibid.

can be a mixed blessing for allocative efficiency. On the one hand, it drives claimants to compete for resources within or across sectors and on the other hand, fiscal discipline may make it more difficult to fund new priorities. Transition countries could stimulate a greater development orientation in public expenditures; that is a shift from current expenditures (i.e. social transfers and expenditures on goods and services) towards investment in capital (i.e. infrastructure). Crucial to this process is that the government links policy formulation to budgeting to enable a discussion and evaluation of objectives, policy options and trade-offs.

### 2.2.1 How to achieve allocative efficiency?

Institutional arrangements that facilitate strategic prioritization in face of budget realities refer to the following main features:<sup>12</sup>

- *A medium term expenditure framework (MTEF)*: A framework that balances the national policy priorities with what is affordable, including a process to identify and discuss the medium term costs of competing priorities at Cabinet level. A MTEF not only contributes to the objective of aggregate fiscal discipline, but it is also an instrument to improve allocative efficiency. It links policy making and planning to budgeting and facilitates the management of government programmes by bringing together policy priorities and budget realities throughout the whole budget cycle. Credible multi-annual budget targets provide a clear resource constraint and, at the same time, predictability of funding for line ministries in order to take decisions on the best mix of resources and the most appropriate timing of expenditures in pursuing programme objectives;
- *Flexibility for the line agencies to make intra-sectoral allocations*: because they have better information on how best to allocate within their sectors to achieve given objectives;
- *Consultations on priority setting*: Broad consultations that involve representatives of claimants (i.e. line ministries and spending agencies) provide oversight at relatively low transaction costs and can help arrive at strategic priorities. After the government has drafted the budget, it needs to be discussed and approved by Parliament;
- *Design accountability and transparency mechanisms that bind politicians and bureaucrats to the achievement of strategic outcomes*: This includes, for example, the reconciliation of the discrepancies between budget and final accounts, the monitoring and evaluation of the policy results, the dissemination of results to the public, the setting of hard budget constraints to create incentives to prioritize expenditures, and to build the technical capacity of Parliament to evaluate the draft budgets.

12 E. Campos and S. Pradhan (1996), Budgetary Institutions and Expenditure Outcomes: Binding Governments to Fiscal Performance, World Bank Policy Research Working Paper, No. 1646.

## 2.2.2 Experiences of transition countries

One of the most essential reforms for promoting allocative efficiency in the budget process of transition economies has been the attempt to design a fully-fledged MTEF. Notwithstanding its significance for providing a baseline for and enforcing fiscal discipline of all main budget aggregates, a MTEF is particularly important for facilitating inter- and intra-sectoral resource allocation and hence strategic prioritization of expenditures. An important feature of a MTEF is that it provides a framework for the integration of capital and current expenditure. MTEFs help to identify the medium term costs of competing priorities and trade-offs between competing programmes, and assists in the measurement of the budgetary impact of policy changes.

The recognition that expenditure adjustments and related implementation of fiscal policies can only be envisaged over the medium term has stimulated transition countries to progressively shift the focus away from annual budgeting. The short term budget horizon stimulates ad hoc and piecemeal financing and neglects the implications of past and present decisions beyond the next year. Budgets tend to be used to allocate funds to existing commitments and programmes rather than as a vehicle to rationalize policy and resources, and seek for the most efficient expenditures for a given set of objectives. The growing burden of mandated (i.e. social transfers, health insurance) and quasi-mandated expenditures (i.e. payroll of civil service) further constrains the government's room for manoeuvring in the short run. To provide a timeframe in which meaningful policy change can be initiated and budget choices can be guided towards expenditure priorities and take into account trade-offs, a small but growing number of transition countries has started to make annual budget decisions within a medium term context.

However, if its objectives and principles are not well understood, a MTEF is likely to be little more than a technical exercise. In particular, the experiences of transition countries with introducing MTEFs underline the following main lessons:<sup>13</sup>

- *Link multi-annual projections of budget aggregates to the annual budget cycle:* They have to be entirely integrated and linked to the budget and policy planning cycle for becoming a true fiscal management tool. Furthermore, multi-year estimates (made by line ministries) need to be squeezed into the macro constraint of the MTEF;
- *Revise incentives and information demands for evaluating programme effectiveness:* It takes time before the incentive structure is sufficiently altered in order to have multi-annual budget requests of government agencies in

13 The World Bank (1998), *Public Expenditure Management Handbook*, Chapter 3: Linking Policy, Planning and Budgeting in a Medium term Framework; and R. Allen and D. Tommasi, *Managing Public Expenditure – A Reference Book for Transition Countries*, Chapter 6: Multi-year budgeting and investment programming, SIGMA, Paris.

line with forecasts of revenues. Also, the type and volume of information needed and associated costs for evaluating the effectiveness of programmes tend to be important hurdles in the process of introducing MTEFs. Decentralizing the reallocation process and entrusting spending departments with most operational decisions can ease the informational burden by reducing the volume of operational detail produced by departments for central review and by delegating much of the analysis and evaluation to spending units;

- *Create capacity for evaluating expenditure implications and policy analysis:* this facilitates policy dialogue on the most effective set of policies and can enhance the sustainability of reforms. The analytical skills of officials in both the MoF and line ministries need to be strengthened in order to evaluate the (medium term) budgetary impact of spending proposals as well as their efficiency and effectiveness in relation to government objectives.

## 2.3 Operational efficiency

In addition to the efforts to attain fiscal consolidation and a prioritization of expenditures, budgetary reform in transition economies has also focussed on encouraging operational efficiency in the use of budgeted resources. Operational efficiency aims at implementing programmes and delivering services at the lowest costs, i.e. achieve outputs at the lowest possible cost. Efforts have centred on resolving the principal agent problem within government hierarchy. The efficient delivery of government services by spending units is often impeded by information asymmetries and incentive incompatibilities. Spending units possess superior information on how best to implement certain programmes because of their closeness to the client and their involvement in the daily operations in a specific (sub-) sector. Providing the right incentives to spending units is therefore imperative to guarantee an efficient and high-quality service delivery. This can be achieved by giving them a greater degree of managerial freedom over specific resource allocations and hold them accountable for implementing their respective budgets. Strengthening the operational efficiency of budget systems requires that better incentives are provided to align resources with policies and performance, and that effective ex post internal and external controls and audit systems are promoted.

### 2.3.1 How to achieve operational efficiency?

The following main elements of managerial accountability contribute to operational efficiency gains:

- *Managers are given control over global operating budgets:* Within a certain budget total, managers have the discretion to use inputs freely. This provides incentives to be efficient because managers have to consider that spending more on some activities will mean fewer resources that are available for other activities;

- *Costs are allocated to outputs or activities:* Operational efficiency of managers is further stimulated by charging them for the full costs of producing the outputs and of carrying out required activities. This can be achieved by using cost allocation methods like activity-based costing;
- *Expected outputs are specified in advance:* This can be done either in the course of compiling the budget or in contracts between managers and their superiors. Accountability frameworks shift the focus of control from inputs to outputs and from what managers are buying to what they are producing.

### 2.3.2 Experiences of transition countries

Many transition countries have the intention to move ahead towards performance budgeting and managerial accountability. But getting the budget to be an instrument of performance has proven to be difficult to implement. This is because of the burden of weak internal management systems inherited from central planning which necessitates further fundamental reforms at the operational level; that is in areas like management, accounting, information technology and human resource development. Under central planning, line agencies had little incentives to develop management systems in order to judge the efficiency with which inputs generated outputs, or delivered services. Internal management was characterized by compliance with detailed spending priorities set at the central government level. It was directed at preserving or increasing historical levels of funding rather than making these funds more productive in terms of final outputs. Managers had no incentive to spend their funds better, as any more efficient meeting of norms would most likely result in future funding being decreased.<sup>14</sup>

The experiences with the introduction of performance oriented budgeting to improve operational efficiency have highlighted the importance of reforming associated internal management systems, as follows:<sup>15</sup>

- Information is often unavailable, not easily accessible and lacks user-friendliness and relevance in order to evaluate the efficiency of operations and the results achieved with public funds;
- The imposition of performance indicators tends to make the officials focus too rigidly on the achievement of specific (quantifiable) targets. Concentrating on narrowly defined activities rather than wider organizational objectives may sacrifice the quality of service delivery;
- Difficulties have been encountered in designing suitable performance measures. Performance criteria often lack the necessary clarity and rele-

<sup>14</sup> J. Diamond (2002), *The Micro Basis of Budget System Reform: The Case of Transitional Economies*, IMF Working Paper, No. 105.

<sup>15</sup> J. Diamond (2003b), *Performance Budgeting: Managing the Reform Process*, IMF Working Paper, No. 33; A. Schick (2003), *The Performing State: Reflections on an idea whose time has come but whose implementation has not*, OECD Journal on Budgeting, Vol. 3, Issue 2; J. Diamond (2003a), *From Program to Performance Budgeting: The Challenge for Emerging Market Economies*, IMF Working Paper, No. 169.

vance, the ability to measure performance and inadequately take into account the costs associated with data collection;

- The costing methodology for performance budgeting tends to be neglected. Most accounting systems do not have adequate mechanisms to fully cost programmes, so that the programme outputs can be related to their budgetary costs and ultimately to their benefits in order to judge programme performance;
- Incentive structure for management and staff is often underdeveloped, lacking the right mechanisms to attract qualified staff and reward good performance.

Performance budgeting aims at providing a more direct link between allocating resources through the budget and performance in reaching stated objectives. In a strict sense, it promises a rational, mechanistic link between performance and resource allocations, with the ability to state the level of outputs that can be achieved with an additional amount of resources. However, outputs (the products or services delivered by government) cannot always be quantified precisely and for outcomes (the policy effects in society) this is even more difficult. Moreover, it is often very difficult to determine a causal relationship between government activities and outcomes, given the importance of external factors and the time lag that often exists between policy implementation and the moment when the effects become visible. While performance information offers benefits to governments, it cannot eliminate the inherently political nature of budgeting.<sup>16</sup>

Based on international experience, it is misleading to push performance based budgeting as a reform that provides a mechanical link between budgets and performance. Budgets should first of all be related to needs, while performance should be stimulated by measuring results and instruments such as benchmarking. To prevent that this would ruin the quality of reporting on performance, it should be done outside the budget process and without the risk that sanctions are taken against underperformance.

A first step to provide better information to legislators and the public would be to restructure the budget. Important improvements can be made with regard to the structure of the budget by making a clear distinction between coherent policy areas and making it more programme oriented. Introducing a programme classification (instead of only having an economic and/or functional classification) is a useful step to provide more information in the budget on how the government is using its resources. Programmes should consist of a coherent set of activities that the government is implementing in particular policy areas. The transparency of the budget can be substantially

<sup>16</sup> World Bank (2003), Performance-based budgeting: beyond rhetoric, PREM Notes, No. 78.

improved by showing the activities of the government under the various programmes in different policy areas.

## 2.4 Baseline measures

To implement successful reforms, first the objectives of the reform should be defined and, second, a comprehensive assessment of the strengths and weaknesses of the budget system should be made to identify the changes that are necessary. A budget reform should generally include a set of complementary actions in several areas. Narrowly focused reforms are often disappointing. Transition countries should aim at a proper mix of measures in order to meet the three basic objectives of budgeting – fiscal discipline, effective resource allocation and operational efficiency – in a balanced manner and taking into account the country's context. The essential requirements of a well functioning system to aim at initially, could be focused on the following baseline measures:<sup>17</sup>

- *Institutional framework*: Clearly defined principles should be set out in a country's constitution, the organic budget law and related laws. The regulatory framework should provide a sound balance between the legislative and the executive powers. The budget should cover all revenues and expenditures.
- *Medium term fiscal framework*: Budgetary information should be provided within a medium term framework and medium term fiscal objectives should be set.
- *Budget preparation process*: There should be a well defined sequence of steps in the budget preparation process, allowing sufficient time for each step to be implemented efficiently. Procedures used for preparing the budget for recurrent and capital expenditures should be integrated. Hard budget constraints should be included.
- *Budget execution and monitoring*: The line ministries should enforce spending limits and the MoF should be able to supervise these limits. The MoF should monitor and control the flow of expenditures during the year on the basis of a unified system of financial accounts. Line ministries should make regular reports to the MoF that compare actual spending with monthly forecasts based on the budget appropriations. The cash management function should be strictly managed through a treasury single account under the control of the MoF.
- *Accounting and reporting*: Budget accounting categories should have a common system of classification that facilitates policy analysis and promotes accountability. Fiscal reporting should be timely, comprehensive, reliable and identify deviations from the budget. Procedures for evaluating the efficiency and effectiveness of expenditure should be established.

17 R. Allen and D. Tommasi (2001), *Managing Public Expenditure – A Reference Book for Transition Countries*, SIGMA, Paris.

- *Financial control*: The systems, principles and functioning of internal control should be defined, including standards and regulations for financial reporting, ex ante controls of commitments and payments, control of revenues and internal audit.
- *Procurement systems*: Sound procurement policies and practice can reduce costs; produce timely results; stimulate the development of the private sector; and reduce waste, delays, corruption and government inefficiency.
- *Budget management of EU Funds (when relevant)*: The European Commission expects that candidate countries for EU membership prepare themselves for managing the pre-accession funds so that, when they join the EU, they have the required budget and control instruments in place.



# 3 Implementing budgetary reforms: the role of capacity building

In chapter 2 the content of budgetary reform has been discussed, based on the three basic objectives of public expenditure management systems: aggregate fiscal discipline, allocative efficiency and operational efficiency. It has provided the theoretical background to see what are the budgetary reforms that are needed in transition countries. In this chapter, the focus will shift to the role that capacity building can play in achieving the basic objectives of public expenditure management. This chapter has been based on the lessons learned that are described in the literature and on the experiences in three case studies: the Czech Republic, Latvia and Bulgaria. More information on budgetary reform and the role of capacity building in the case studies is given in the annexes A, B and C.

In section 3.1 the concept of capacity building is described and how it is related to improving public expenditure management. Furthermore, in this section attention is given to the priority areas that need to be strengthened first and to the important role of technical assistance for the strengthening of budgetary institutions in transition countries. A distinction can be made between three levels of capacity building that are needed for improving public expenditure management: commitment and leadership from the top, capacity building at the organizational level, and capacity building at the individual level. Sections 3.2 through 3.4 provide for each of these levels the basic elements that need to be addressed for successful and sustainable capacity building.

## 3.1 Capacity building

### 3.1.1 What is capacity building?

The term “capacity building” (or “capacity development”) came into vogue in the early 1990s among international development agencies such as the World Bank and the United Nations Development Programme (UNDP). The UNDP defines capacity building as “the process by which individuals, organizations, institutions and societies develop abilities (individually and collectively) to perform functions, solve problems and set and achieve objectives.”<sup>18</sup> In

<sup>18</sup> UNDP (1997), Capacity Development, Technical Advisory Paper 2, p. 3 cited in: M. Schacter (2000), “Capacity Building”: A New Way of Doing Business for Development Assistance Organizations, Institute On Governance, Policy Brief No. 6.

this study we will follow the definition of UNDP. However, many other definitions and perspectives on capacity building are commonly used in the literature.

The various definitions and perspectives could be grouped into four major approaches to capacity building: organizational, institutional, systems, and participatory.<sup>19</sup>

The organizational approach sees an entity, organization or even set of organizations as the key to development. In this view, capacity building refers to the improvements in the ability of public sector organizations, either singly or in cooperation with other organizations, to perform their tasks.<sup>20</sup> The advantage of the organizational approach is that it is relatively focused and the unit of change is clear. On the other hand, it could result in a narrow focus since organizations are only part of the picture.

The institutional approach looks broader than organizations and focuses on the formal and informal “rules of the game” that determine the behaviour of organizations and individuals. Institutional approaches build the capacity to create, change, enforce and learn from the processes and rules that govern society.

In the systems approach, capacity building is a complex intervention that encompasses multiple levels and actors, power relationships and linkages. Systems extend beyond the individual and organizational levels to systems of organizations, their interfaces, and the institutions that guide them. The advantages of the systems approach are that it is comprehensive, flexible and emphasizes linkages between elements. However, what it sometimes lacks is focus. Since the concept itself is broad and encompasses everything, it is unclear where one starts in a system change effort.

While not ignoring the goals of development, the participatory approach to capacity building emphasizes the importance of the means used to achieve them. Those who view development as people centred and non-hierarchical believe that unless capacity building is a participatory, empowering partnership for which those involved feel a high degree of ownership, intended results cannot be achieved.<sup>21</sup> Perhaps because of the importance of people in this approach, the focus of change is often the individual. And although individual change is important, it is also important to determine when the

19 An overview of various definitions of capacity building and description of these four major approaches is given in: C. Lusthaus, M. Adrien, M. Perstinger (1999), *Capacity Development: Definitions, Issues and Implications for Planning, Monitoring and Evaluation*, Universalial Occasional Paper, No. 35.

20 Grindle, M.S. & M.E. Hilderbrand (1994), *Building Sustainable Capacity: Challenges for the Public Sector*, New York: HIID/UNDP.

21 Fowler, A. (1997), *Striking a Balance: A Guide to Enhancing the Effectiveness of Non-Governmental Organizations in International Development*.

qualitative and quantitative changes in individuals add up to capacity development.

Improving public expenditure management in transition countries requires reforms of budgetary rules and procedures (institutional reform) as well as organizational development. Budgeting organizations can be improved but the behaviour of organizations and individuals will not change unless the (in)formal rules and procedures change as well. At the same time, a change of the rules by itself is unlikely to produce beneficial results unless organizational improvements proceed in parallel. Therefore, capacity building within the MoF and line ministries is essential to make the new rules and procedures work in practice. Officials should develop new ideas about public expenditure management and adopt new working methods in order to achieve the three objectives of aggregate fiscal discipline, allocative efficiency and operational efficiency.

From the experience of government modernization programmes in transition countries we can conclude that getting agreement from top decision makers that the budget system needs to be made more flexible may not be such a problem. Similarly, designing the organizational and procedural changes required is not so difficult. However, the real constraint is the human element in implementing institutional change.<sup>22</sup> Therefore, in this study we will in particular focus on capacity building at the level of organizations and at the level of individuals (human resource management), which are closely interrelated in practice.

Capacity building at the organizational level focuses on organizational structures, processes, resources and management styles that affect how individual talents and skills are used to accomplish particular tasks.<sup>23</sup> This is an important dimension because organizations establish goals, structure work, define authority relations, and provide incentives and disincentives that shape the behaviour of those who work within them. They define and encourage management practices that increase or decrease the productivity of officials and units. They also provide the environment within which officials are able or unable to develop their skills and careers.

Capacity building at the individual level looks at human resources. It relates to the recruitment, training, utilization, and retention of managerial, professional, and technical talent that contribute to task performance at the organizational level. Recruitment refers to the process of attracting skilled

22 Particular attention to the institutional aspects of budgetary reform is given in: J. Diamond (2002), *Budget System Reform in Transitional Economies: The Experience of Russia*, IMF Working Paper, No. 22 and J. Diamond (2003b), *Performance Budgeting – Managing the Reform Process*, IMF Working Paper, No. 33.

23 Grindle, M.S. & M. E. Hilderbrand (1994), *Building Sustainable Capacity: Challenges for the Public Sector*, New York: HIID/UNDP.

individuals to fill critical roles and positions in public sector organizations. Training involves professional education required for filling particular roles and functions within organizations. This level of capacity also directs attention to how talents are used, for example how well positions and responsibilities are matched with skills, and the ways in which professionals are encouraged to develop meaningful careers in the organization.<sup>24</sup>

Finally, a distinction could be made between the “hard” and “soft” elements of capacity building.<sup>25</sup> The “hard” elements refer to things like personal skills, functions, structures, systems and to factors such as equipment, infrastructure and financial resources. The “soft” elements refer to less easily definable and quantifiable factors. These are often related to incentives and motivational factors of a material, cultural or social nature. For individuals, this may mean financial, career and professional incentives, or more widely to questions of attitude and mind-set. At the organizational level, this can refer to aspects of legitimacy, norms and values, as well as to wider questions of governance.

### 3.1.2 Capacity building to improve public expenditure management

For successful and sustainable implementation of budgetary reforms, the institutions that play a key role in the budget process need to be strengthened. The reform not only requires different rules and procedures, but also a change of the behaviour of public officials and often the development of new skills. Therefore, capacity building is a crucial element for many aspects of budgetary reform in transition countries. Sufficient attention should be given to the knowledge and skills of civil servants in order to make the new rules; procedures and working methods also work in practice. In particular, when the scope of reform is broadened beyond fiscal discipline to include also allocative and operational efficiency, capacity building becomes increasingly important, since more and more people will be involved to make the reforms successful. Not only a relatively small number of financial staff within the Ministry of Finance needs to adopt new working methods, but also the officials within line ministries and government agencies will be given increased responsibilities that require different behaviour and new skills.

Capacity building is relevant in all phases of the budget cycle: budget preparation, execution, accounting and reporting, and audit. Examples of capacity building could be to strengthen government institutions with regard to macroeconomic forecasting, programme budgeting, treasury, internal and external control mechanisms or fiscal risk management. Attention could also be given to other participants in the budget process outside the MoF and line ministries, for instance strengthening the capacity of the Supreme

<sup>24</sup> Ibid.

<sup>25</sup> Land, A. (2000), *Implementing Institutional and Capacity Development: Conceptual and Operational Issues*, ECDPM Discussion Paper 14, Maastricht: ECDPM.

Audit Office to critically assess government spending and Parliament to better understand and evaluate budgetary documents and financial reports.

**Box 3.1**      **Latvia: Capacity building at the State Treasury**

Capacity building at the State Treasury in Latvia implied the establishment of a new structure. This structure was put in place with the support of a PHARE sponsored project on “Technical Assistance to the Budgetary and Treasury Process” between 1996 and 1999. It led to a Treasury in Latvia that is organized along classic treasury lines with a clear separation of functions between the front office (responsible for foreign and domestic financial resources as well as budget execution), the middle office (in charge of risk management and government accounting) and the back office (responsible for operations). The development of integrated treasury operations has enabled the Ministry of Finance to execute cash management and debt management at one place and to react more swiftly on budgetary developments. It allowed control of cash outlays and to put an end to the flow of funds through own bank accounts of the individual ministries.

The main organizations, roles and functions that are important for successful public expenditure management could be identified as follows:

- Budget Directorate within the Ministry of Finance: to control spending of line ministries within total and sectoral expenditure ceilings and assess its efficiency and effectiveness; to coordinate the budget process and maintain its procedures;
- Financial Directorate within spending ministries: to control sectoral spending and assess efficiency and effectiveness of its expenditures;
- Treasury: is responsible for cash management to make sure that the actual payments can take place as well as debt management;
- Internal Audit Office: to perform internal audit function, looking at regularity of spending (compliance), the financial control system and the performance of government expenditure (efficiency and effectiveness);
- External Audit Office: is responsible for independent ex post audit of government expenditure and preferably reports directly to Parliament.

**Box 3.2**      **The Czech Republic: Capacity building at the Supreme Audit Office**

In the Czech Republic, a recent PHARE twinning project has been of particular importance for the strengthening of the Supreme Audit Office (SAO). In the project, twinning relations were established with the German Supreme Audit Institution. The overall objective of the twinning project was to strengthen external financial control functions of the SAO to the level of the Supreme Audit Institutions in the EU member states.

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Most important for this were pilots on financial and performance audits that were supported by German and British short term experts. The pilots were successful concerning improvements in using European standards and training auditors on the job and giving them more self-confidence. The pilot audits were conducted in accordance with the INTOSAI Auditing Standards and the European Implementing Guidelines. In addition, the audit capacity was developed by several intensive seminars, workshops, lectures and direct consultancies. Furthermore, in total 8 study strips were organized to the German Federal Court of Audit, the European Court of Auditors and the National Audit Office in London. The value of the study trips was obvious. The participants received the opportunity to see on site the practical work of professionals, who have profound audit experience. This experience was normally not open to them in their own SAO.

The overall design of budget reform depends on the specific circumstances in a country. For those countries with governance problems, the foremost objective should be to ensure compliance with the financial laws and regulations. For those transition countries faced with a high degree of fiscal stress, the need to ensure macroeconomic objectives will be paramount. For those countries that can ensure compliance with the law and have reached a fair degree of macroeconomic stability, more attention can be paid to ensuring efficiency and effectiveness of resource use, as currently emphasized in the OECD countries.<sup>26</sup>

**Box 3.3      Sequence of budgetary reforms in Latvia**

In the 1990s Latvia made significant changes in the establishment of agencies, devolution of financial responsibilities to the line ministries and also in programme budgeting. However, most of the changes had been introduced at a very high speed, without significant support and overlooking the wider implications. At the end of the 1990s, Latvia understood more and more that public administration and budgetary reforms required a more careful, gradual approach involving all major institutions and considerable support. Then, Latvia followed the preferred mode of sequencing by firstly strengthening budget execution, internal controls and internal audit, particularly to address mistakes in the past with the too swift devolution of financial management to the line ministries and other spending agencies. Only in the latter years, serious attention was paid to the budget planning and preparation phase to address the too fast introduction of programme budgeting in 1996. Reforms in the budget planning and preparation phase are still at an early stage.

<sup>26</sup> J. Diamond (2003b), Performance Budgeting – Managing the Reform Process, IMF Working Paper, No. 33.

Many transition countries have the intention to move ahead towards performance budgeting and managerial accountability. Performance budgeting aims at providing a more direct link between allocating resources through the budget and performance in reaching stated objectives. An important first step for transition countries would be the introduction of programme budgeting to improve the link between policy and budget. Programme budgeting could be defined as a (re)classification of expenditures according to policy areas and with reporting on results.

In general, for transition countries, it is important to follow a logical sequence of steps. Only when managers can be trusted to spend inputs properly, and efficiently and responsibly produce budgeted outputs, does it make sense to move management structures towards internal control and managerial accountability (see also box 3.1)

**Box 3.4      Ten basic principles of budgetary reform**

- 1 Foster an environment that supports and demands performance before introduction of performance or outcome budgeting.
- 2 Control inputs before seeking to control outputs.
- 3 Account for cash before accounting for accruals.
- 4 Establish external control before introducing internal controls.
- 5 Establish internal controls before introduction managerial accountability.
- 6 Operate a reliable accounting system before installing an integrated financial management system.
- 7 Budget for work to be done before budgeting for results to be achieved.
- 8 Enforce normal contracts in the market sector before introducing performance contracts in the public sector.
- 9 Have effective financial auditing before moving to performance auditing.
- 10 Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

Source: The World Bank (1998)

Technical assistance has been important for the strengthening of budgetary institutions in transition countries. In particular in the early 1990s the influence of the IMF and World Bank was strong. Later attention shifted to technical assistance from the EU for transition countries that had the perspective of EU accession. For these countries, the accession process has significantly contributed to capacity building in the area of public expenditure management. Moreover, the exchange of ideas with colleagues at international meetings and reading international literature has led to increased capacity as well as to a harmonization of public expenditure management with international best practices.

**Box 3.5**      **Technical assistance in the Czech Republic**

In the first years of transition, the IMF and World Bank were very important for the reform agenda in the Czech Republic. The IMF provided a lot of technical assistance in the areas of public expenditure management and tax administration. Besides, it has given assistance in other areas such as monetary management, foreign exchange operations, banking supervision and statistics. The World Bank has supported key structural reforms and the modernization of individual sectors through financial and technical assistance. From 1998 onwards, the WB assistance was mainly provided through analytical and advisory services. It included for instance the EU accession process, capital and financial market reform, enterprise restructuring and fiscal management.

In the second half of the 1990s the influence of the EU increased substantially, especially in the last years towards accession. The European Commission reviewed the Czech legislation, which led to many recommendations for reform, in particular in the area of financial control. In preparation for EU accession, many technical assistance projects have been implemented under the PHARE programme, for instance in the areas of taxation, customs, capital markets and money laundering. At present, PHARE projects are being implemented in the areas of internal control and state treasury reform.

**Box 3.6**      **Technical assistance in Latvia**

While some forms of technical assistance in Latvia were targeted to one institution or department only, there have been larger projects, which focused on more than one department. For instance, a large PHARE Public Expenditure Management project in 2002 and 2003 involved the Budget department, the Economy Analysis and Fiscal Forecasting department, the Internal Audit department as well as the State Treasury. The five components of the project were: strengthening the fiscal forecasting function; follow-up to the implementation of the budget planning IT system; multi-annual budget planning; sound financial management; and development of the internal audit function.

The State Treasury considers that the following factors played a role in using technical assistance effectively: well prepared receiving institutions, highly qualified experts, twinning projects (“practical and useful”) and combination of theory to foster new ideas and to change people’s minds and views as well as practical support in implementation issues.

### 3.2 Capacity building: the need for leadership and commitment

The implementation of major reforms in (government) organizations generally requires strong commitment and leadership from the top management. For as far as budgetary reforms are concerned, the Ministry of Finance, and most specifically the budget department, should be the key agent of change, which is going to recognize the need for reform, design the reform, and monitor and implement the reform. However, a new budget management model that moves away from compliance and stabilization objectives and begins to emphasize efficiency and effectiveness in resource use does not automatically attract support from the budget department.<sup>27</sup> Often there is a concern that relaxing central controls and giving budget programme managers greater personal freedom, will result in more waste and corruption. Indeed, there is the risk that this may happen, in particular when accounting and internal control systems of line ministries are rudimentary and poor. It is therefore important that these risks are minimized, which can be achieved by improving financial control systems within line ministries and upgrading their financial management skills. As a prerequisite for devolving budgetary responsibilities to line ministries, priority should be given to financial control issues, in order to offer assurances to the budget department about the fiscal responsibility of spending agencies.

If one wants to build a commitment for budgetary reform, the proposed changes cannot ignore the interests of key stakeholders, in particular the central budget department and the targeted spending agencies. The reform process should therefore safeguard the basic controls of the Ministry of Finance and, at the same time, provide management tools, which are desired by the spending agencies.

#### Box 3.7

##### **Bulgaria: Involvement of Parliament in budgetary reform**

In Bulgaria, the role of Parliament has been constructive but merely following the developments that happened in budgetary reform. Members of Parliament have shown increasing attention for budgetary implications of policies and become more aware of the rules and procedures governing the budget. Although MPs have very diverse backgrounds it is left to the political parties themselves to organize technical and professional courses for them. An additional advisor has raised the capacity of the Committee in recent years. In the beginning of the 1990s the Budgetary Committee and advisors went frequently to other countries to inform themselves about modern budgetary practices made possible under several externally funded programmes. However, in recent years Parliament has not been explicitly involved in budgetary reform programmes, except for attending meetings or workshops that are deemed necessary for the advisors to the Committee.

<sup>27</sup> J. Diamond (2003b), Performance Budgeting – Managing the Reform Process, IMF Working Paper, No. 33.

Leadership and commitment from the central budget department is essential for the successful implementation of budgetary reform measures. However, it is not sufficient. For the budget department as key agent of change, it is crucial to build up a consensus for reform among the other participants that are involved in public expenditure management:<sup>28</sup>

- The Minister of Finance and Deputy Ministers of Finance should be committed to the reform measures and they should have support from the Prime Minister and Cabinet. Legitimacy for the implementation of budgetary reforms needs to be provided at the political level.
- Parliament should be consulted about changes in the legal framework (e.g. the introduction of a new budget law) or substantial changes in the format of the budgetary documents. When the presentation and content of the budget will be improved, it is also important to take measures to enhance the capacity of members of Parliament to analyze the new materials, for instance by training them.
- Within the ministries, the middle management should be fully informed about and supportive of the objectives of the proposed reforms and the measures required to implement them. Senior officials should participate in an appropriate way in the reform activities in order to create ownership. Particular attention should therefore be given to how to manage the process in order to gain acceptance and active cooperation.
- Operational staff in the MoF and line ministries should also understand and support the changes in order to implement them successfully. Actions aimed at promoting and communicating the changes might include workshops and wide dissemination of documents. Moreover, it is important at each stage of the reform process to highlight information on progress made in an appropriate, widely circulated newsletter, to encourage feedback from all staff, and to make necessary adjustments to the reform activities.

**Box 3.8**

**The Czech Republic: Importance of political commitment**

The Czech Republic has had a reform minded government in the early 1990s. At that time, the public also expected unpleasant reform measures. The government implemented many reforms such as privatization, liberalization of the economy and opening of borders. Because of the relatively good economic situation that developed during the 1990s, there was less need for implementing drastic budget reform measures. At present, the politicians in the Czech Republic have accepted that fiscal consolidation is needed. The political willingness to implement painful reform measures has been influenced by external pressure from international organizations such as the EU, IMF, OECD and WB.

28 R. Allen and D. Tommasi (2001), *Managing Public Expenditure – A Reference Book for Transition Countries*, SIGMA, Paris.

Realizing ‘quick wins’ can be useful to build and maintain consensus for reform measures among the various participants that are involved at different levels. For instance, clear advantages and benefits of new working methods need to be shown as early as possible. This helps to motivate the people involved to implement further measures that may be more difficult and may need more time before the positive effects become visible. It is also good to follow a step-by-step approach and not to set targets too high directly at the beginning. In this way the chances are lower that people become disappointed and no longer support the reform measures when things turn out to be more difficult and take more time than expected. In general, based on lessons learned, it can be recommended to begin modestly and not to attempt to be too ambitious. In design, a gradualist rather than a “big bang” approach to budgetary reform is advocated, while in implementation, a serial approach is preferred.<sup>29</sup>

**Box 3.9 EU influence on budgetary reform in Bulgaria**

The European Union and the European Commission have been and still are important for budgetary reforms in Bulgaria for several reasons. The prospect of EU accession provides an overarching long term strategy for Bulgaria, including for budgetary reforms. Secondly, accession to the EU asks for specific measures for the control of EU funds. The establishment of a National Fund within the Ministry of Finance is an important example of such a measure. The National Fund is a central treasury entity within the MoF that handles and disburses the EU’s external assistance, which is a mandatory requirement. Also in the field of audit, both internal and external, the EU *acquis* has specific regulations that have to be implemented by Bulgaria. Thirdly, the EU has been a major supporter of budgetary reforms through several capacity building projects in particular in the Ministry of Finance. In effect, the EU financed the preparation and implementation of large parts of the Medium Term Strategy for the Ministry of Finance.

Moreover, to build and maintain a commitment for reform, external pressure is important. For the implementation of budgetary reform measures, external pressure could come from outside the country, for instance from the European Commission (if a country is in the process of EU accession) or International Monetary Fund (if a country receives loans under certain conditions). Also within the country, the government can be put under pressure to improve its public finance management, for instance by the Central Bank, the Supreme Audit Office or the private sector.

29 J. Diamond (2003b), Performance Budgeting – Managing the Reform Process, IMF Working Paper, No. 33.

### 3.3 Capacity building at the organizational level

#### 3.3.1 The structure of organizations

At organizational level, it is important to look at how individual talents and skills can be used to accomplish the particular tasks of the organization. What is the best organizational structure to perform new tasks and could a reorganization contribute to better performance? How are authorities divided between the various organizations that are involved in the budgetary process? Do spending agencies have a large degree of budgetary autonomy or is there strong external control from the Ministry of Finance? Which responsibilities are given to the various organizations at different levels and what instruments do managers have to perform their tasks successfully?

##### **Box 3.10 The organizational structure of the Czech Ministry of Finance**

In the Czech Republic, changes in the organizational structure of the Ministry of Finance are necessary. At the moment, coordination problems exist between different departments within the Ministry of Finance, since the State Budget Department and the Sectoral Departments that deal with the individual budget chapters are under the responsibility of different Deputy Ministers. This makes cooperation within the MoF difficult, since there is no frequent contact between the Budget Department and the Sectoral Departments. The Minister of Finance has decided to have an organizational audit for the Ministry, starting in the autumn of 2004. The audit should provide recommendations how to reorganize the MoF and reduce the number of its staff. The intention is to retain the total salary costs at the same level and have less but better paid staff.

#### 3.3.2 The culture of organizations

Another important factor for capacity building is the culture of the organization. There may be a need to change the organizational culture, for instance to create an open culture in which professionals are stimulated to discuss issues with their superiors and take initiatives themselves. Leadership can be very important to change the culture of organizations in order to better achieve the goals of the organization.

##### **Box 3.11 Changing organizational culture in Bulgaria**

Changing the culture of an organization is notoriously difficult and so are the experiences in the Ministry of Finance in Bulgaria. An important element, implicit sometimes, is the shift to a more modern and performance oriented culture in budgeting but also in the organization. In general, Ministries of Finance may be particularly poor predisposed for such a change. They tend to be rather conservative in culture and even cherish this as an effective and desirable cultural element. From this perspective,

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cultural revolutions are not possible therefore and not even desirable, as they would probably lead to a sudden loss of well established norms and codes. The Bulgarian MoF tries to cope with this paradox by slowly but steadily hiring young staff to bring in new talents with fresh ideas, while maintaining a solid base of proven knowledge and experience.

The budgetary reforms in transition countries demand a new role and other competences for the public managers as well as for the officials working at operational level.<sup>30</sup> With the budget focused on inputs and detailed line item controls on expenditures, agencies focused on obtaining spending approvals and utilizing them within the year. Since little attention was paid to performance, management in line agencies have not been used to subjecting new policy proposals to neither critical analysis nor managing expenditure to achieve results. Many officials of line ministries in transition countries have spent most of their working lives in this centralized compliance-oriented environment with little emphasis placed on performance. Their reflex responses are to manipulate detailed external control systems to protect their programmes from the cash rationing operations of the MoF. Often they see their role as administrators, distributing limited cash to keep basic services functioning. In a new budget system in which financial autonomy will be devolved to spending agencies, the staff will no longer be administrators, but are expected to accept increased managerial responsibilities.

### 3.3.3 Financial Management Information Systems

Often, information systems need to be developed in order to provide the new information requirements for budget preparation, execution as well as accounting and reporting. The availability of well functioning instruments such as a Financial Management Information System (FMIS) can be an important element for successful capacity building in public expenditure management.

**Box 3.12**      **Financial Management Information Systems in Latvia and Bulgaria**  
Major concerns existed concerning the information systems being used by the State Treasury in Latvia. They were considered to be ad hoc and in danger of not being able to cope with changes to the budgetary and treasury processes. Much effort has been made to resolve this. Although the development of the information technology has been considered as difficult, the present system enables management of debt flows. The next step forward will be to integrate it with the budget execution system. The execution of the budget is still facilitated by two IT systems: an in-house budget execution system based in Oracle, which is a one year →

30 J. Diamond (2003b), Performance Budgeting – Managing the Reform Process, IMF Working Paper, No. 33.

database reporting system with no financial accounting function, and SAP, which includes a multi-year financial accounting module that currently is not linked to the budget execution system. At present, all information recorded in Oracle is transferred to the SAP system. The latter system does have a budget execution module and will replace the existing in-house budget execution system in the long term. A related problem has been the implementation of a budget planning IT system at the Budget department, which optimally should be linked to the treasury systems. Although, the system has been developed, the system is not yet fully operational. The major obstacle has been that system design has not fully taken into consideration users' preferences. It is felt that the system is impeding the daily operations of the Budget department rather than assisting the department.

Also in Bulgaria, the development of a Financial Management Information System (FMIS) has been difficult. Preparations for it started already in 1998, but no complete rollout to spending agencies has yet taken place. As of today only one module of the SAP-system is currently fully functioning. It is considered one of the 'headaches' in budgetary reform in Bulgaria and the system as well as the implementation process is currently subject of reflection in the MoF. A strategy on FMIS development is under development for some time but not yet approved. The new system is regarded too complex, needs much more maintenance than was originally envisaged and a full implementation will consume much more resources than expected. Another issue that affects implementation is the difficulty to coordinate activities across ministries without a specific organizational structure that is backed at ministerial level. Similarly, it is difficult to convince spending agencies to start working with new systems as these are in effect additional, which creates double work, because the old system cannot be discarded yet.

#### 3.3.4 Building financial management capacity in spending ministries

The MoF should adopt a proactive role in the development of good financial management in the spending agencies to which it provides budget funding. This is a key element in the budget reform model based on devolution of financial freedoms. It should develop competencies in the evaluation of internal resource allocation processes in spending agencies. These should focus particularly on the ability of spending agencies to critically assess budget proposals, identify cost ineffective aspects of their activities and to re-assign resources away from such areas. The MoF could provide performance linked institutional rewards, job transition assistance and trainings to the line ministries. The ultimate goal for the MoF would be to have line ministries that undertake internal reallocation and identify savings in response to external budget management requirements.

It must be recognized that building management capacity in an input and compliance oriented budget system will take time and needs to be developed in stages. For instance, in Thailand agency access to more managerial autonomy has been made conditional on improved agency financial management (the “hurdle approach”). Detailed centralized controls over line agencies were made conditional on their achievement of hurdle standards.<sup>31</sup> These standards cover the core financial and performance management competencies that a line agency needs to substitute its resource management system for external, centralized controls. External controls can then be loosened with less risk of wasted resources and greater chance of attaining better outcomes from government spending. The hurdle approach differs from traditional approaches to budget reform in two main ways. First, the easing of central controls is formally linked to the strengthening of line agency management systems. Second, central controls are being reduced on an agency-by-agency basis. Devolution of budgetary authority is conditional on individual agencies achieving hurdle standards. It is a way of minimizing the risk of misuse or abuse of managerial authority, while recognising that agency capacity building will take time.

Devolution of budgetary responsibilities from the central MoF to spending ministries is a process that involves two different approaches at the same time. On the one hand, it shows trust in the capacity of spending ministries to use budgets in a responsible manner by delegating authority to them and no longer demanding ex ante approval of all budgetary decisions. On the other hand, it requires strong internal control systems within the ministries and independent external audit afterwards. Attention should be given to the “human factor” that people in line ministries may look at these two approaches as being contradictory. However, to prevent misuse of public funds, it is important to make sure that a good system of checks and balances is in place. It must be clearly communicated and explained to spending ministries that increased budgetary autonomy should be accompanied by increased accountability. These are two sides of the same coin.

### **3.4 Capacity building at the individual level: human resource management**

Individual capacities, such as the knowledge and skills to perform new functions, can be acquired through training. Training can be considered as necessary but not sufficient for capacity building within government organizations. It is important that trained staff is also able to use their new knowledge and skills when they go back to their day-to-day work practice. New functions need to be created and competences need to be developed to determine the requirements for the new functions. What qualities should people have to perform successfully, given their new roles and responsibilities? How

<sup>31</sup> A description of this hurdle approach is given in: World Bank (2002), Thailand’s hurdle approach to budget reform, Public Sector Notes, No. 73.

well can positions and responsibilities be matched with the skills people have and made best use of the talents within organizations? Attention should also be given to other elements of human resource management, such as recruitment of qualified staff, reward systems and career development opportunities to prevent good people leaving the organization.

**Box 3.13 Human Resource Management in the Bulgarian Ministry of Finance**

A separate goal of the organizational restructuring of the Ministry of Finance in Bulgaria was to increase and professionalize the attention for human resources. Before Human Resources was often considered more a unit for legal issues in personnel affairs. To signal the new status the existing Human Resources Division was made a Directorate and allocated additional staff. The Directorate has been put in a position to significantly alter its previously administrative role and the perception of others as to the services it can provide and the value it can add to the Ministry as a whole. The increase in the number of staff has created further opportunity to augment existing administrative functions with the provision of more strategic and proactive services, for example in the areas of performance management, compensation and benefits, and training and development.

In its new role the Directorate has focused initially on establishing and implementing procedures for selection and staff assessment, procedures that had not been there or were outdated before. New selection procedures included special attention on professional tests and interviews as well as language skills. The new HR Directorate also played an important role in defining new, modern job descriptions that were in line with the new functional characteristics that were developed for the restructuring of the ministry. In the last year the Directorate also managed to start working with regular training programmes for staff and managers in the Ministry. The development of the HR Directorate has benefited greatly from the new standards that were developed under the Civil Service Reform. It received on-the-job coaching from international and national advisors, short term as well as long term, for a period of about two years.

#### 3.4.1 Recruitment and retention of staff

A constraint on attempts to improve the capacity of organizations with regard to public finance management is the shortage of particular skills that may arise, such as auditors that can often get much better paid jobs at private accounting firms.

**Box 3.14 Attractiveness of jobs in the Czech state administration**

There are big differences within the Czech state administration in attractiveness of jobs. In general, the Ministry of Finance has less difficulty in attracting good and motivated people than most other ministries. As one senior official of the MoF said, “the attractiveness very much depends on the agenda you can offer them”. Departments that can provide access to international organizations can be quite attractive for young people. For instance, the Financial Policies Department is successful in hiring well educated young people, because it works a lot with international organizations (e.g. the EU, IMF, OECD) and the staff is awarded the opportunity to go abroad. The Department started with 6 people, now it has 35. The main expansion was in the last 5 years, all by recruiting external people. Of the present staff, 18 are below 30.

Moreover, there may be a risk that trained and experienced staff leave to the private sector if the salaries are substantially higher than in the public sector. Therefore, capacity building and training of staff should also be linked to wider public sector reform programmes to address these particular problems. For instance, if ministries reduce the number of staff, they could use the savings on the wage bill to increase government salaries in particular areas (such as auditing). Financial incentives could be introduced that are linked to the performance of individuals, allowing for more differentiation in government wages.

**Box 3.15 Low turnover of staff in the Latvian State Treasury**

Whilst changes in managerial skills and in organizational culture did not receive much attention in Latvia, there were exceptions to this rule. For instance, in the State Treasury turnover of staff has been relatively low. The deputy State Treasurer considered that this has been due to: open minded senior management able to make changes; senior management knowing how to motivate staff; possibility to follow training and even study abroad when senior management sees potential; and young staff being coached by senior staff.

### 3.4.2 Trainings

Given the skills required to implement budget reforms, an extensive training programme for each phase of the budget cycle is essential for successful implementation.<sup>32</sup> For instance, to improve budget preparation it is necessary to increase capacity within the MoF and spending agencies to define

32 R. Allen and D. Tommasi (2001), *Managing Public Expenditure – A Reference Book for Transition Countries*, SIGMA, Paris.

clearly the objectives of public expenditure and make informed choices among competing programmes. Such capacity could be developed in training sessions. These trainings could include various elements, such as improving analytical methods, discussing sectoral policy issues and “learning by doing” activities. The training programmes must be prepared in advance and require a detailed review of existing skills and training needs. The MoF should ensure that all training activities fit in the common framework dictated by the (new) budgetary laws and procedures. For this purpose, the trainers should be well informed of the existing system and the intended reforms.

It is important that the training of staff moves in parallel with the progress that is made in the different aspects of the budget reform programme. When trainings have been organized to teach participants to change their roles and working methods or how to work with new budget procedures and budget formats, they should be able to adopt their new skills and attitudes in their daily working environment. If their work practice does not change or these changes lag far behind, they will easily forget what they have learned and lose interest in the reforms.

**Box 3.16      Trainings on public finance management in the Czech Republic**

As part of its technical assistance to the Czech Republic, the World Bank has organized a training programme on modern public expenditure management for officials of the Czech state administration. The training programme consisted of two day and five day training courses focused on medium term budgeting, programme and performance oriented budgeting and audit in public administration. The two day seminars were meant for senior officials of the central government. The main purpose of these seminars was to create a platform for discussion on necessity and direction of further budget reform steps.

In the five day training courses on public expenditure management more than 120 people participated. Besides the MoF staff, there were representatives of all ministries and central bodies. Most of them were directors of departments or heads of units responsible for the budget chapter of the particular ministry. Also lecturers and researchers of the university as well as staff members of the Supreme Audit Office were present. The lecturers combined presentations with discussion, case studies and simulations. The participants worked in groups while conducting analysis, finding solutions for practical problems and presenting the results. The training of staff members of both the MoF and line ministries were of considerable benefit.

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Recently new trainings on public expenditure management have been organized to staff of the Ministry of Finance and the Ministry of the Interior. The OECD handbook on transition economies was used in the training. Some people were open to new approaches, others were not, but most of them assessed the training positively. They could use what they learned when they advise directors and ministers on decisions that are related to the budget. They know better now how to analyze the budget chapters and they do better understand what additional information is needed in order to make a good assessment of the proposals. Giving the training courses was not so easy as the trainers thought in the beginning. For the lecturers of the university, it was very difficult to make it practical and connect it to the daily work practice of the civil servants. The training was therefore also useful for the lecturers themselves.

The content of training activities can vary between general or highly specialized, basic or high level, focused on technical knowledge or on skills and behaviour. With regard to the fields of training in relation to public finance management reform, one could think of the use of new budgeting concepts and procedures; the use of new financial management information systems; the application of new public procurement legislation; the use of software packages for computerized HRM systems; the use of internal audit as a management tool; and general training on foreign languages. Training of budget managers should not be limited to specific techniques and methods, but also be aimed at providing them with information on the context of modern budgeting systems and increasing their awareness of macroeconomic and EU financing issues.

**Box 3.17**

**The establishment of a Public Finance School in Bulgaria**

A major initiative in terms of capacity building in Bulgaria has been the establishment of the Public Finance School (PFS) of the MoF. After several years of preparation the PFS was created in 2003 and had its formal opening in April 2004. It is considered an integral part of the overall reform process. The PFS was created as a practical tool directed to the needs of the administration, and instrumental to harmonization of budget principles and procedures in line with the EU requirements. At the same time the tendency towards decentralization of the budget process requires a major effort to build up capacity in spending units and municipalities.

The PFS puts a lot of effort into establishing the training needs of different target groups, developing training programmes and conducting training courses and seminars. It makes use of staff of the MoF under the leading principle of ‘practitioners train practitioners’. In its short life

span more than 500 employees of the public administration have already been trained and 22 courses and seminars conducted. The existing curriculum includes topics as diverse as:

- Medium term expenditure planning and programming;
- Methods and techniques for performance and programme budgeting;
- Financial Management Information System;
- Budgetary accounting and reporting;
- Financial Audit and Control;
- Management of EU projects and programmes;
- European Integration in the financial and budget area; and
- Didactical skills.

The PFS uses knowledge and experience from international experts and links were established with several institutions, including the National Academy for Finance and Economy in the Netherlands and the Centre of Excellence on Public Finance in Slovenia. General support for the concept of a Public Finance School was built by promoting it during various courses provided under ongoing external support programmes of the MoF. During these courses also the first potential trainers were identified. In addition to these informal preparations, explicit attention was also asked from the Council of Ministers on the necessity and importance of the PFS. The PFS received financial and technical assistance in the set-up and development of the school and continues to receive assistance through a full time resident expert of the Netherlands Ministry of Finance (Dutch MATRA-programme).

### 3.4.3 Twinning projects and study tours

Various other instruments besides trainings have been used in transition countries to develop the competences of public officials. There have been many twinning projects with financial support of the EU. They provide useful input as the organizations can learn from the experiences of their counterparts in other countries. Also study tours have in many cases been an effective instrument to develop knowledge and skills. In particular it has been very useful when the study tour included side-by-side working on an ordinary job. Also workshops in which real life situations are simulated have been very effective.

#### **Box 3.18**

##### **Latvia: Strengthening macroeconomic and fiscal forecasting**

The Economic Analysis and Fiscal Policy Department of the Latvian Ministry of Finance exists since 1996. The department works together with the Ministry of Economy whose macroeconomic modelling results are imputed in the fiscal forecasting models of the department. Capacity building interventions were focussed on training abroad, development of new models by foreign experts in close cooperation with the depart-

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mental staff and twinning. A twinning project with the German Ministry of Finance included the development of a new expenditure model. Staff considers that the models are used in practice for policy purposes and indicated that “about 80% of the results of technical assistance are used”. Besides advice on updating models as part of the PHARE Public Expenditure Management project, a study tour to the Netherlands was organized during which the Netherlands Bureau for Economic Policy Analysis (CPB) was visited to discuss the role of macroeconomic models in the Netherlands policy debate, and to the Ministry of Finance to discuss how the Netherlands deals with the contributions to the EU (including forecasting of these contributions, negotiations with the EU and the impact on the budget).



# 4 Conclusions and lessons learned

Based on the experiences of Bulgaria, Latvia and the Czech Republic, the lessons that can be learned from practice are formulated. The key questions of this study are:

- 1 What role has capacity building played in implementing the reforms in transition countries?
- 2 How can capacity building be organized in the most effective way to contribute to successful and sustainable implementation of budgetary reforms?

## 4.1 Role of capacity building in budgetary reform

Important areas for capacity building in the Czech Republic, Latvia and Bulgaria that have contributed to achieving and maintaining fiscal discipline include:

- *Macroeconomic and fiscal forecasting*: to have the budget based on realistic macroeconomic assumptions. For instance, capacity building interventions took place in the Economic Analysis and Fiscal Policy Department of the Latvian Ministry of Finance. The activities were focused on trainings abroad, development of new models by foreign experts in close co-operation with the departmental staff and a twinning project with the German Ministry of Finance.
- *Treasury*: to control cash management during budget execution. For instance, capacity building at the organizational level in Latvia implied the establishment of a new structure for the State Treasury that is organized along classic treasury lines with a clear separation of functions between the front office (responsible for foreign and domestic financial resources as well as budget execution), the middle office (in charge of risk management and government accounting) and the back office (responsible for operations).
- *Financial control and internal audit*: to assure compliance with the budget. For instance, in the Czech Republic, an EU PHARE twinning project is being implemented to develop capacity in the area of financial control and internal audit according to the EU regulations, involving day-to-day financial management and control systems, systems verification (internal audits) and expenditure verification (checking expenditure on a risk analysis basis).

- *External audit:* to have a well functioning independent Supreme Audit Office to critically assess government spending. For instance, the National Audit Office in Bulgaria has seen a boost in its human resource capacity in terms of numbers of staff, it has had several twinning relationships with Supreme Audit Institutions of different EU countries to learn about new instruments for audit and it has developed its own system of train-the-trainers to cope with the large demands for training.

In the Czech Republic, Latvia and Bulgaria further improvements in the second and third objective of public expenditure management – allocative and operational efficiency – are needed. Capacity building is of crucial importance for improving allocative and operational efficiency of public expenditure in transition countries. An important area for reform in this respect is the introduction of programme budgeting to improve the link between policy and budget. Programme budgeting could be defined as a (re)classification of expenditures according to policy areas and with reporting on results. Capacity building in this area is not limited to the staff of the Ministry of Finance, but also involves programme managers and financial staff of spending ministries that need to change their working methods and, even more important but also more difficult, adopt a different result oriented attitude towards public expenditure.

In the 1990s Latvia embarked on a swift introduction of programme budgeting without really overseeing the implications of introducing such radical reforms. As a result, the programme structure of the budget was in name only and in 2002 it was believed that improvements had to be made. A stronger link had to be established between policies and budgets and also the “management of programmes” had to be strengthened. Improvement of programme budgeting was addressed by strengthening the performance measurement guidelines and strengthening the link with policies by strategic planning.

In Bulgaria the introduction of programme budgeting has followed a gradual pace so far. A start was made back in 2000 with an experiment to create a programme budget for the Ministry of Environment supported by external assistance. Based on this initial experience a decision was made to implement programme budgeting as a new budget methodology for the whole government. In recent years much time and effort has been spent on improving the methodology on formulation of objectives, programmes and consolidation and allocation of resources. In this process two more pilot ministries were selected. According to plan the rollout of the new methodology is to be completed in 2006. Although the rollout of the methodology for budget preparation has received much attention, the current challenges are to also adapt accounting and reporting to the new methodology.

In recent years, also in the Czech Republic increasing attention has been given to allocative and operational efficiency. The government had set its first steps towards programme budgeting in 2001 with the introduction of a programme classification for capital expenditure. In 2003 the possibility of including programmes in the budget was extended to all expenditures, although it is still on a voluntary basis. Spending ministries are requested to link their budgets to programmes. As a result, they now put in more effort to think about objectives, activities, efficiency and effectiveness of their budget proposals. However, the introduction of programme budgeting in the Czech Republic is still at an early stage and will need time to be implemented successfully.

What role has capacity building played in implementing the reforms in the selected transition countries? On the basis of the experiences in the Czech Republic, Latvia and Bulgaria, it can be concluded that capacity building is of crucial importance for achieving the three objectives of public expenditure management: aggregate fiscal discipline, allocative efficiency and operational efficiency. We have observed large variations in size, focus, approach and methods of capacity building activities, but our general impression is that they have been of enormous significance for the improvements in public expenditure management in the selected countries. Capacity building is relevant in all phases of the budget cycle: budget preparation, budget execution, accounting and reporting, and internal and external audit. Capacity building does not only relate to the Ministry of Finance but also to other parties involved in budgetary reforms, such as spending ministries, the Supreme Audit Office and Parliament.

## **4.2 Organization of capacity building**

Capacity building requires a comprehensive approach, involving efforts at three levels of budgetary management: commitment and leadership from the top management, capacity building at the organizational level and capacity building at the individual level (the use of human resources).

### **4.2.1 Capacity building: the need for leadership and commitment**

First, capacity building requires strong commitment and leadership from the top management. For as far as budgetary reforms are concerned, the Ministry of Finance, and most specifically the budget department, should be the key agent of change, which is going to recognize the need for reform, design the reform, and monitor and implement the reform. In Bulgaria the MoF has large powers to decide on budgetary issues and budget allocations. It is for instance the sole presenter and defender of the full budget in Parliament and up to now has the discretionary power to decide on disbursements during budget execution without the need for prior approval of Parliament. The reforms in and by the MoF in the past decade in Bulgaria have been very diverse and far reaching.

However, other organizations can play a lead role as well. For instance, in Latvia reform in the sphere of budget planning and budget preparation has primarily been promoted by a new department in the State Chancellery, i.e. the Policy Coordination Department that was created in the fall of 2000, in response to the recommendations in an influential report on Public Administration Reform. The Policy Coordination Department is formally responsible for leading the government's priority setting process, and coordinating all products for Cabinet's review and approval.

#### 4.2.2 Capacity building at the organizational level

Second, capacity building requires reforms at the organizational level. At the organizational level the focus is on organizational structures, processes, resources and management styles that affect how individual talents and skills are used to accomplish particular tasks. It involves both the structure and culture of organizations as well as instruments that managers have to perform their tasks successfully.

For the implementation of budgetary reforms changes in the organizational structures can be important. In the Czech Republic, a reorganization of the Ministry of Finance is necessary to solve coordination problems that at present exist between different departments. An organizational audit will be conducted to see how the MoF can be reorganized and how its staff can be reduced. However, restructuring of an organization does not automatically solve all problems and may create new problems. In Bulgaria, the Ministry of Finance was restructured in order to accommodate a new role for the ministry and facilitate a longer term approach towards budgeting, but there is still a lack of horizontal coordination structures.

Another important factor for capacity building is the culture of organizations. There may be a need to change the organizational culture, for instance to create an open culture in which professionals are stimulated to discuss issues with their superiors and take initiatives themselves. Many officials of line ministries in transition countries have spent most of their working lives in a centralized compliance oriented environment with little emphasis placed on performance. With the budget focused on inputs and detailed line-item controls on expenditures, agencies focused on obtaining spending approvals and utilizing them within the year. Often officials see their role as administrators, distributing limited cash to keep basic services functioning. In a new budget system in which financial autonomy will be devolved to spending agencies, the staff will no longer be administrators, but are expected to accept increased managerial responsibilities. Moreover, the broader culture of the society itself may play a role in implementing budgetary reforms.

Other relevant issues to look at include the responsibilities that are given to the various organizations at different levels and the instruments that managers have to perform their tasks successfully. Often, information systems

need to be developed in order to provide the new information requirements for budgetary management. The systems at the State Treasury in Latvia were considered to be ad hoc and in danger of not being able to cope with changes to the budgetary and treasury processes. Much effort has been made to resolve this, but the development of the required information technology has been considered as difficult. Also in Bulgaria, the development a Financial Management Information System has been difficult. Preparations for it started already in 1998, but no complete rollout to spending agencies has yet taken place. It is considered one of the ‘headaches’ in budgetary reform in Bulgaria and the system as well as the implementation process is currently subject of reflection in the MoF.

#### 4.2.3 Capacity building at the individual level

The third level of capacity building is the use of human resources. Capacity building at the individual level relates to the recruitment, training, utilization, and retention of managerial, professional, and technical talent that contribute to task performance at the organizational level.

Individual capacities, such as the knowledge and skills to perform new functions, can be acquired through training. Various training programmes have been organized on public expenditure management for officials of the Czech state administration. The training of staff of both the MoF and line ministries was of considerable benefit. The participants have improved their skills on how to analyze the budget and how to make a good assessment of budget proposals. The lecturers combined presentations with discussion, case studies and simulations. The participants worked in groups while conducting analysis, finding solutions for practical problems and presenting the results. For senior officials of the central government separate seminars were organized to create a platform for discussion on necessity and direction of further budget reform steps.

A major initiative in terms of capacity building in Bulgaria has been the establishment of the Public Finance School of the MoF. It has become an important milestone in the reform process and is a valuable asset in the future process of capacity building in the government. The PFS was created as a practical tool directed to the needs of the administration, and instrumental to harmonization of budget principles and procedures in line with the EU requirements. The PFS puts a lot of effort into defining the training needs of different target groups, developing training programmes and conducting training courses and seminars. It makes use of staff of the MoF under the leading principle of ‘practitioners train practitioners’. The PFS uses knowledge and experience from international experts and links were established with several institutions, including the National Academy for Finance and Economy in the Netherlands and the Centre of Excellence on Public Finance in Slovenia.

Various other instruments besides trainings have been used in transition countries to develop the competences of public officials. There have been many twinning projects with financial support from the EU. They provide useful input as the organizations can learn from the experiences of their counterparts in other countries. Also study tours have in many cases been an effective instrument to develop knowledge and skills. In particular it has been very useful when the study tour included side-by-side working on an ordinary job. Also workshops in which real life situations are simulated have been very effective.

Trainings, twinning projects and study tours can be considered as necessary but not sufficient for capacity building within government organizations. It is important that staff is also able to use their new knowledge and skills when they go back to their day-to-day work practice. New functions need to be created and competences need to be developed to determine the requirements for the new functions. What qualities should people have to perform successfully, given their new roles and responsibilities? How well can positions and responsibilities be matched with the skills people have and best use made of the talents within organizations? A major improvement in Bulgaria in this respect was to make the role of human resources more prominent in the organization and the internal structures and responsibilities more explicitly defined in functional descriptions for divisions as well as job descriptions at staff levels. The existing Human Resources Division was made into a Directorate and allocated additional staff. The Directorate has been put in a position to significantly alter its previously administrative role and provide proactive services, for example in the areas of performance management, compensation and benefits, and training and development.

Attention should also be given to other elements of human resource management, such as recruitment of qualified staff, reward systems and career development opportunities to prevent that good people leave the organization. Recruitment of qualified staff is a general capacity constraint for the state administration in transition countries, given that the salaries are relatively low compared to the private sector. However, there are big differences with regard to attractiveness of jobs. In general, the MoF has less difficulty in attracting good and motivated people than most other ministries, in particular departments that have working relationships with international organizations (such as the EU, IMF and OECD). Retention of good staff is another problem; for instance, the best people are now recruited by the European Commission to come to Brussels. However, there are exceptions. For instance, in the State Treasury of Latvia turnover of staff has been relatively low. This could be related to open minded senior management able to make changes, senior management capable of knowing ways to motivate staff, the possibility to follow training and even study abroad when senior management sees potential and young staff being coached by senior staff.

In order to address capacity constraints in budgetary management in transition countries, our main conclusion is that a comprehensive approach towards capacity building is needed. It is important that capacity building activities take place at all three levels: having commitment and leadership for budgetary reform from the top management, improving the capacity at the organizational level and improving the use of human resources at the individual level.

Moreover, the following lessons in particular can be drawn from the experiences in the selected transition countries:

- 1 It is important to have first a budgetary reform strategy to guide capacity building. This will allow also managing the activities of various donors better, which will increase the effective use of the resources.
- 2 For developing a coherent approach towards budgetary reform and capacity building it is necessary to have a commonly agreed agenda by involving all main reform drivers instead of having separate plans. Foremost, there should be enough reform managers to keep the pace of reform.
- 3 It is vital for maintaining the momentum to involve a critical mass of line ministries. Particularly line ministries and other spending agencies that resist should be supported to accept new budgetary processes as useful and as an opportunity rather than as a centrally imposed burden or a way to introduce budgetary cuts.
- 4 Improved communication structures, both formal and informal, between all institutions involved should receive more attention. Most technical assistance and other capacity building interventions are focused on one institution only.
- 5 Finally, it is important for transition countries to build on their own foundations and not to copy automatically everything from abroad. One should realize that budgetary reform is a process that takes time. First look at what the consequences of changes are, since they can have a negative impact on other things. The challenge is how to develop a new system without losing the good things of the old system at the same time.



# Afterword

This study on the role of capacity building in budgetary reform in transition countries has been based on the theory of budgetary reform and capacity building (as can be found in the literature) as well as on empirical evidence from three selected case studies: the Czech Republic, Latvia and Bulgaria. The work on the case studies started with desk research to document the easily available information on budgetary reforms in these countries. In July 2004, visits were undertaken to Prague, Riga and Sofia to interview key officials that have hands-on experience in dealing with budgetary reforms in the selected countries.

For each visit a tight program of interviews was established in an effort to speak to as many persons as possible in a short period of time. The list of persons included of course a substantial number of senior policymakers in the Ministry of Finance and (in Latvia) the State Chancellery and the State Treasury. In addition, interviews were held with representatives of other organizations involved in the budget process. Visits were made not only to various line ministries, but also to organizations such as the Office of the Government, the Central Bank, the Supreme Audit Office, the Statistical Office and the Budgetary Committee of Parliament. The visits also included interviews with senior representatives of IMF and World Bank, a Pre-Accession Adviser of the MoF and a Project Director of a project supporting the set-up of a Public Finance School. A list of all persons that were interviewed in the Czech Republic, Latvia and Bulgaria can be found in the annexes. We would like to thank all these people for the time they reserved for us to share relevant information and their knowledge on budgetary reforms in their countries.

The interviews in the Czech Republic would not have been possible without the very helpful support of Ms. Milena Horcicova and Ms. Drahomira Vaskova, Director and Deputy Director of the Financial Policies Department. They not only provided very valuable information and useful documents on budgetary reform in the Czech Republic, but they also took the responsibility for organizing many highly relevant meetings.

The author of the study on Latvia (Ferry Philipsen) would like to thank especially Mrs. Inguna Sudraba for providing clear insights in the PFM reform process and for expressing noteworthy views on the necessary conditions to implement reforms in a politically unstable environment. The program of interviews had not been possible without the helpful support of Mr. Ugis Sics of the State Chancellery who made himself constantly available to explain and discuss the reform process in Latvia.

The ambitious program of interviews in Bulgaria had not been possible without the very helpful support of Deputy Minister L. Datzov. In addition, the author of this case study (Arthur ten Have) would like to give a special word of thanks to Mrs. A. Mihailova, Head of the Budget Policy Depart-

ment, who was particularly instrumental and helpful by taking responsibility for organizing all the meetings. Ms. Milena brought very necessary help by translating those interviews that were held in Bulgarian.

Many thanks also go to Mr. Peter Arnoldus, Mr. Bas Verberne and Mr. Pieter van Uden of the National Academy for Finance and Economy of the Dutch Ministry of Finance and Mr. Dirk-Jan Kraan of the Organisation for Economic Cooperation and Development (OECD) for their valuable comments and suggestions on earlier drafts of this report.

On behalf of ECORYS-NEI,

John Zevenbergen.

# Annexes:

## The practice of budgetary reform

In the following annexes the results of the case studies on the Czech Republic, Latvia and Bulgaria are presented. The case studies have been conducted by John Zevenbergen (the Czech Republic), Ferry Philipsen (Latvia) and Arthur ten Have (Bulgaria). Field visits to these countries took place in July 2004.

During the field visits, interviews were held with key officials that are or have been involved in the process of budgetary reform in these countries. In the case studies some attention will be given to the content of the reforms in the Czech Republic, Latvia and Bulgaria (e.g. reforms that were implemented in the last few years and the expectations for the near future), but the emphasis is on how the reforms have been implemented, in particular with regard to capacity building. How has capacity in budgetary management been developed, in terms of “the process by which individuals and organizations develop abilities to perform functions, solve problems and set and achieve objectives”? What are the lessons that can be drawn from practical experience, in particular with regard to capacity building issues?

The case studies are not meant to be academic assessments, but they provide besides facts and the authors’ own observations, the views of the various key actors involved in the budgetary reform process in the Czech Republic, Latvia and Bulgaria. The study is restricted to public expenditure management, though acknowledging the importance to look at the tax administration as well as to wider public administration reform issues.

For each case study the results are presented in the following structure:

- 1 Background of budgetary reform: the political, economic and public finance background as well as a description of the key reforms that were implemented.
- 2 Process of budgetary reform: various critical factors that have influenced the accomplishment of the budgetary reform objectives and the roles of the key institutions that were involved.
- 3 Role of capacity building in budgetary reform: description of the capacity of key institutions for sound public expenditure management and how these institutions have been strengthened at the organizational and individual level as well as views on the role of technical assistance from international organizations, such as the IMF, World Bank, UNDP and EU.

- 4 Conclusions and lessons learned: the main conclusions and specific lessons that can be derived from the practical experiences with implementing budgetary reform in the Czech Republic, Latvia and Bulgaria.

## **Annex A**

### **The Case of the Czech Republic**



# 1 The Czech Republic: background of budgetary reform

## 1.1 General background

The period of transition in the Czech Republic began on 17 November 1989 when the rule of the Communist Party ended. The reconstruction of the state administration and the centralized economic system began in January 1990. The first democratic parliamentary elections since 1946 took place in June 1990. The dissolution of the Federation happened on 1 January 1993 and from that date the split between the Czech Republic and the Slovak Republic was a fact. On 1 January 1993, the Constitution of the Czech Republic entered into force and the public management system for the new Czech Republic was established. The Constitution characterizes the CR as a sovereign, unitary and democratic state, based on the rule of law and on respect for human rights and freedoms. State power is divided between legislative power (which belongs to the Parliament), executive power (with the President as the head of state and the Government as the highest organ of executive power) and judicial power (which is exerted by independent courts).<sup>33</sup> The Czech Republic has a population of 10.2 million and a total area of 78,866 sq. km.<sup>34</sup>

The Czech Republic had the image of being one of the most stable and prosperous post Communist states until the currency crisis of 1997. Delays in enterprise restructuring and failure to develop a well functioning capital market played major roles in the Czech economic problems at that time.<sup>35</sup> The currency crisis led to a new momentum for structural reforms, including privatization, which increased the country's attractiveness for foreign investors and helped modernize the economy. Although it raised unemployment, it set the stage for renewed growth by the late 1990s. With the implementation of structural reforms, the Czech Republic has completed the transition from central planning to EU membership in little more than a decade.<sup>36</sup>

33 Sigma (EU Phare/OECD) paper (1999), Public management profiles of Central and Eastern European Countries: the Czech Republic.

34 European Commission (2002), Enlargement Papers – Progress towards meeting economic criteria for accession: the assessment from the 2002 regular report.

35 Country Report – The Czech Republic (2003) Phare Country Ex-Post Evaluation and Capacity Building.

36 IMF (2004), Czech Republic 2003 Article IV Consultation – Staff Report.

Since the inauguration of the first Czech government in the early 1990s, there has been a large degree of political consensus in support of accession to the European Union. Since then successive governments have maintained this as the essential objective of Czech foreign and domestic policy. The Czech Republic presented its application for membership of the European Union in January 1996. During the 1990s the European Commission had regularly assessed the Czech Republic's progress towards fulfilling the Copenhagen criteria and negotiations for accession were opened in July 1997. The Czech Republic became a new member state of the European Union on 1 May 2004.

**Table 1 Basic economic and financial data on the Czech Republic**

Basic data	2000	2001	2002	2003	2004 f
<i>Real economy *</i>					
GDP (in billions of koruny, at current prices)	2,1501	2,3153	2,4147	2,5324	2,735
Real GDP growth (change in percent)	3.9	2.6	1.5	3.1	3.8
CPI (year average)	3.9	4.7	1.8	0.1	2.9
Unemployment rate, year average (in percent)	8.8	8.9	9.8	10.3	10.4
<i>Public finance (percent of GDP)**</i>					
General government revenue	38.5	39.1	40.2	41.9	
General government expenditure	42.1	45.0	46.9	54.5	
General government balance	-3.7	-5.9	-6.8	-12.6	-4.4
General government debt	18.2	25.3	28.8	37.8	38.4
<i>Balance of payments (percent of GDP)***</i>					
Trade balance	-5.6	-5.0	-3.0	-2.7	-1.8
Current account	-4.9	-5.4	-5.6	-6.2	-6.0
Net foreign direct investment	8.9	9.0	11.2	2.6	2.7 2Q
Gross official reserves (in months of imports of goods and services)	4.1	3.9	5.6	5.0	4.6

(2004: MoF forecast; 2Q – second quarter 2004)

(Source: \* CSU; \*\* Eurostat – Euro indicators 117/2004 23.9.2004; \*\*\* CSU, CNB)

## 1.2 The budget process

The preparation of the State Budget and its implementation is better organized now than before, although there have not been changes in the division of responsibilities between the Ministry of Finance and the spending ministries. The responsibilities for budget management are to a large extent delegated to the line ministries. Ministers are responsible for their own budget, including budget preparation, execution and reporting as well as for

their own internal control system. The spending ministries have financial departments to deal with budget management issues. The budget in the CR is cash based. Amendments during budget execution need to be approved by the MoF. When the proposed amendment involves more than 10%, approval of the Budget committee of Parliament is required. The main reason for introducing this rule in the new budget law (2000) was to increase the role of Parliament. It has resulted in more discipline and less amendments during budget execution. From 2004, 100% carry over of funds is allowed.

### **1.3 Financial control and internal audit**

In the Czech Republic each ministry has its own financial control mechanisms, but a strong central control function by the MoF is lacking. For instance, if the MoF wants to introduce particular requirements for line ministries, it needs to draft a law that has to be approved by Parliament. The position of the MoF was further weakened when the EU made the Ministry of Regional Development responsible for the EU funds instead of the MoF. A big mental division exists between the financial control mechanisms for EU funds and for the national funds. The European Commission (DG Enlargement) has a strict approach towards accountability and countries only receive EU money if all financial control systems are in place. According to a pre-accession adviser of the MoF, the risk exists that EU funds will not be (fully) allocated to the Czech Republic because good systems are not in place (while the EU funds have already been projected in the budget). The substantially shorter funding round (2004 to 2006), together with the reliance on basically new and operationally untested systems are significant threats.

In 2002 financial control and internal audit offices were established in the MoF and line ministries. They all have their own inspections, but because a centralized methodology for conducting audits is lacking the results can be different. Therefore, it is important to get to international (EU) standards. In the Czech Republic financial control mainly consists of compliance controls (which is inherited from the old regime), while not much attention is given to control systems and value for money audits.

Part of a recent PHARE twinning project on Treasury reform is a new financial information system that will contribute to more transparency and better financial control mechanisms. At present financial control is focused on on-site inspections, but it is not very efficient because there are many delays in the information flows. With the new system information can be checked online, which makes it possible to react immediately. A better selection can be made of where to go for a visit and check, which will contribute to the efficiency and effectiveness of the inspections.

Besides its own financial control and internal audit unit, the MoF also has a Department that coordinates the internal control function for all ministries.

At present this Department prepares a policy paper on financial control, dealing with issues such as legislative changes, reorganization, unified methodology and trainings on financial management and internal audit. In the policy paper attention will be given to the strengths and weaknesses of the current financial control system, improvements of the financial control system in accordance with international standards and EU harmonization, strengthening of internal audit and the functions of the Supreme Audit Office. It is expected that the policy paper will be presented to government by the end of November. A consultation phase with different working groups that involve all government levels is part of the preparation process to come to a consensus about the reforms.

#### **1.4 External audit**

The Supreme Audit Office of the Czech Republic is an independent supervising authority. After the Czech Republic became a separate state in January 1993, the present Supreme Audit Office was established in July 1993. It monitors expenditures and revenues of the state budget and enforces laws dealing with economic and financial issues and the execution of public tasks. It reviews the annual report on the state budget accounts and draft acts and regulations concerning budgetary and other financial issues. It is a member of the international organization of audit institutions INTOSAI and of the European regional organization EUROSAI.

The Supreme Audit Office in the Czech Republic is mainly looking at compliance. Recently, the SAO has conducted a pilot financial audit and two pilot performance audits with the support of German and British short term experts. The pilots were used for training of the auditors to work with the INTOSAI Auditing Standards and the European Implementing Guidelines. The pilots were part of a PHARE twinning project with the German Supreme Audit Institution (Bundesrechnungshof).

#### **1.5 Extra budgetary funds**

Since 1990, various extra budgetary funds (EBFs) have been created in the Czech Republic. At present there are nine EBFs (e.g. State Fund for Soil Fertilisation, State Fund for Culture, State Housing Development Fund and State Fund for Transport Infrastructure). Two large and special funds were established in 1991: the Czech Land Fund and the National Property Fund. The latter is the most important extra budgetary fund. It is charged with implementing the privatization decisions of the government. Until recently, the share of these funds in total spending was declining, but in 1999 two new EBFs were created: the State Fund for Transport Infrastructure and the State Housing Development Fund. However, in 2005, a number of EBFs will be abolished (draft laws have been prepared and already submitted to Parliament).

The funds are not subject to the same budgetary rules as the state budget. In particular, the approval and monitoring processes are not as comprehensive and some are allowed to carry over their surpluses, can borrow from financial markets, issue guarantees and finance their deficits by selling their assets or reducing their deposits. The state budget only specifies and monitors the direct funding provided to the funds. Given their capacity to take on debt, their actual spending can exceed that amount substantially. Thus, even though EBFs accounted for only 4.8% of consolidated general government spending in 2000, they accounted for 36.5% of the overall deficit. Indeed, in recent years most of the increase in the deficit has occurred within these funds with the majority of the shortfall having been generated by the National Property Fund.<sup>37</sup>

Extra budgetary funds did not have a formal mechanism for approval of expenditures and contingent liabilities accumulated that were not properly accounted for. The creation of these funds resulted in a lack of budgetary control by the central government and a lack of transparency of public funds. In 1998, after the financial crisis, a World Bank project started to make the contingent liabilities explicit and include them in the budget. EU accession has also improved budget transparency because of the standard EU accounting norms that have to be followed.

## 1.6 Fiscal consolidation

The Government expects that the Czech Republic will join the euro zone around 2009-2010, provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, and provided that a sufficient level of real convergence is achieved and adequate progress has been made with structural reforms guaranteeing sufficient economic alignment with the EU Member States.<sup>38</sup> At present, the only real macroeconomic problem is the budget deficit. The CR initially had a low level of public debt, but in recent years the debt rapidly increased (as someone from the Central Bank said, “the Czech Republic is moving towards Maastricht criteria from below instead of from above”).

The high budget deficit poses an obstacle on the road towards compliance with EU convergence criteria. It is mainly caused by problems on the expenditure side. Most expenditure is mandatory (based on laws, for instance with regard to pensions, health care and social welfare), resulting in extremely small room for discretionary expenditure. Moreover, the CR needs to bring down its mandatory expenditure to make resources available for co-finan-

37 Andrew Burns and Kwang-Yeol Yoo (2002), Improving the efficiency and sustainability of public expenditure in the Czech Republic, OECD Economics Department Working Paper, No. 328.

38 Convergence Programme of the Czech Republic 2003-2007, May 2004.

cing of EU Structural Funds (so to receive more money from EU, additional cuts in expenditure are needed).

The Government has adopted a strategy aimed at fiscal consolidation to reduce the deficit to 4% of GDP in 2006, 3.5% in 2007 and 3% in 2008. Fiscal consolidation was laid out in two stages. During the first stage, which was approved in June 2003, the emphasis was put on bringing the deficit trend to a halt and on slowing down the public debt increases. The measures focused on raising tax revenues and getting the growth of social transfers, the government wages bill and other expenditure categories under control. In the second half of 2003 Parliament gradually passed laws that put these measures into practice.

On the revenue side, tax reform measures were drawn up to harmonize the Czech tax legislation with the appropriate EU directives. The central element is a fall in income taxes compensated for by a reinforcement of indirect taxes. Important changes that were approved include a reduction of VAT from 22% to 19%, a raise of excise duties on commodities where Czech rates were lower than the minimum rate levels applied in the EU and reduction of the corporate income tax rate to 28% (with a further reduction to 26% and 24% in the next 2 years). With the implementation of these measures the harmonization of taxes, which was needed for EU accession, has succeeded.

On the expenditure side, different saving measures were identified. Although the primary objective was to accomplish budgetary savings, many of the measures improved economic incentives and contributed to increased use of the labour force. Among measures with such effects are the increase in retirement age until the target age of 63 years is reached, a lower level of sickness benefits for the first three calendar days of sick-leave from 50% to 25% and abolition of the restrictions on earning while drawing maternal leave benefits. Other savings that were identified included a minimal indexation of pension benefits, abolition of the transportation benefit and a decrease in the number of employees at the central government level by 6% in the period 2004 to 2006.

The first stage of budget reform has been successfully implemented. According to the officials that were interviewed, the present measures will for the first time lead to real pain for the population (for instance for pensioners). However, they also indicated that the saving measures that were agreed so far were only the small and relatively easy things that remain on the surface while no decisions have been taken yet on big structural savings. The second stage of budget reform will consist of long term structural changes, such as pension and health care reform. Since these are long term reforms, the intention is to have them based on consensus of all parties in Parliament. However, there are different views and it may take time before the coalition government and opposition will come to an agreement.

In general, all politicians agree that the deficit should be lowered, but ministers are not in favour of cutting their spending on concrete programmes. The Czech government has sent its Convergence Programme for the next 3-4 years to Brussels and now they have to implement this programme to comply with EU requirements. The external pressure from the EU plays an important role in achieving fiscal discipline. For instance, in a recent government meeting for next year's State Budget they had a big discussion about the level of expenditure. The Prime Minister literally said to the other ministers: "you have to decrease your expenditure, I promised it in Brussels!"

## **1.7 Budgetary reform**

One of the priority measures for fiscal reform in the early 1990s was the reform of the tax structure (that was very fragmented and consisted of all different rates for income and corporate taxes). The tax reform started in 1991 and was quite comprehensive. The initial phase was completed in 1993 with the introduction of VAT.

Another important area of reform was the change of the administrative structure of the government, including the fiscal relations between the central and local government. Since the early 1990s there has been a permanent discussion about what responsibilities and what revenues should be at what level of government. Initially, four levels of government were introduced (central, regions, districts and municipalities), then it was changed to three levels and later regions were re-introduced (although different regions than before). So the trend has moved from decentralization to centralization and now to decentralization again. At present the administrative structure consists of the central government, 14 regions, circa 80 districts and about 6000 municipalities.

Reforms on the expenditure side started with the restructuring of state owned enterprises (privatization) including changes in the state subsidies to these enterprises. Fiscal consolidation measures were politically more difficult to implement and limited progress has been made in this area so far. Decisions to bring down the expenditure level – which are necessary to lower the deficit and comply with Maastricht criteria – have been postponed and are still under discussion. They require legislative changes with regard to the pension system, social welfare and the health care system.

Recently, two major reforms have been introduced that will significantly improve public expenditure management in the Czech Republic. In June 2003, the government decided to introduce a medium term expenditure framework and programme budgeting.

### 1.7.1 Introduction of MTEF

In 2001 a medium term outlook was introduced into the budget for the next 2 years. Although it was treated rather as an informative document, it has been an improvement compared to the previous situation, which practically included no element of medium term thinking. In order to meet its fiscal targets, the government decided in June 2003 to introduce a Medium Term Expenditure Framework (MTEF) from 2004 onwards with binding nominal ceilings that limit the total volume of expenditure of the state budget (and extra budgetary funds) within a three year horizon. On 1 August 2004, Parliament approved the Amendment of the Act on Budgetary Rules, which introduces fiscal targeting based on these binding nominal medium term expenditure limits. The amended Act, which is valid from 7 September 2004, significantly changes the institutional framework for the performance of fiscal policy. Parliament will not only approve the expenditures for the budget year, but also the ceilings for the following two years. Later, Parliament is allowed to change the ceilings only in special circumstances (e.g. situations where real price development will significantly diverge from the forecast or where legislative changes modify the allocation of expenditure authority to individual levels of government).<sup>39</sup> The expenditure limits can also be increased by the amount of expenditure co-financed by the EU. Changes in revenue (because of lower economic growth) will lead to changes in the deficit and not directly in the level of expenditure, resulting in anti-cyclical fiscal policy.

The introduction of medium term budgeting is a major improvement to achieve budget discipline. Besides, the approved medium term expenditure framework will help the administrators of budget chapters to plan much more rationally their activities and programmes for the budget chapter entrusted to them. However, it still has to be implemented. Spending ministries do not always understand the reforms and, in general, are not in favour of hard ceilings. The political commitment of individual ministers and the cabinet as a whole is crucial to implement the medium term expenditure framework successfully. In this respect, it is encouraging that already this year the ministers remained within their ceilings for 2004, although these were introduced on an experimental basis (before the Amendment of the Act on Budgetary Rules was approved).

### 1.7.2 Programme budgeting

Under the socialist regime, the Czech government had a budget process that was more suitable for state planning than for fiscal management or the efficient provision of public services. It was not encouraged to think about why money was spent on something. Financial staff were not used to question of why some activities cost more this year than last year. In general, in the past there was not much attention for 'value for money'.

39 Convergence Programme of the Czech Republic 2003-2007, May 2004.

Some legacies of state planning are still visible in Czech budgeting, despite numerous advances during the 1990s. Compliance with budget rules and procedures is high and expenditures are properly controlled and reported. Most budgetary institutions have trained staff who go about their work in a professional, though sometimes rigid, manner. The adequacy of budgetary control is not a problem, but the adequacy of budgetary information is.<sup>40</sup> To improve the adequacy of information in the budget, medium term programme budgets were introduced for capital expenditure in 2001. Furthermore, in June 2003, the government decided that budget items on recurrent expenditure could also be on a programme basis, although this was voluntary and no detailed requirements were given on what programme budgets should look like. It was decided that budget chapters should provide particular information on the programmes and activities that the budget funds are allocated to. Line ministries have the responsibility for the preparation of programmes and the MoF has to approve them. When different ministries are involved, programmes are formulated at cabinet level.

The budget chapter administrators were not very used to monitoring outputs and social effects of their programmes or evaluating the efficiency and effectiveness of government expenditure. Therefore, in spring 2003, the Ministry of Finance organized an expenditure review. The MoF prepared a questionnaire for line ministries to give information on issues such as the purposes of expenditure, its justification, efficiency, effectiveness and results. Budget chapter administrators made a report according to the standard format that included the detailed questionnaire as well as their own comments and conclusions. The answers were discussed with the MoF. For the most important budget chapters, the results were discussed in sessions that also included external experts, for instance from other central bodies, universities or the Central Bank. The results were used for the preparation of the draft state budget 2004. According to the MoF, spending ministries were, not surprisingly, mainly using the expenditure review to justify their need for more money, not as a critical evaluation of their activities.

At present, there are big differences in the quality of programmes. Some of the budget chapters are now more oriented towards programmes and activities than before, others are still mainly on the basis of economic classification. Some programmes are very well defined and worked out, while others are not. For ministries it is difficult to prepare the necessary information on programmes. This is further complicated by the fact that in the last two years responsibilities have shifted to regional and local government. For instance, the Ministry of Education is no longer responsible for primary and secondary schools but only for universities and the Ministry of Health is now only responsible for academic hospitals. These broader public administration

40 A. Schick (2000), *Strategies for implementing medium-term and performance-oriented budgeting in the Czech Republic*.

reforms complicate policy making and require a new approach to achieve policy objectives.

According to senior officials of the MoF, line ministries now put in more effort to think about goals and calculate costs of activities. In the past they came to the MoF with ad hoc budget proposals that were not based on clear documents and they did not think about efficiency or effectiveness. Now they are obliged to explain why they need the money, how they want to use it and what results they expect. Developing programmes and becoming more oriented to results is a continuing process of change that will take time. It requires not only new working methods but also another attitude towards spending.

In the past, the World Bank (together with NEI) has organized trainings in the area of programme and performance oriented budgeting. At present, the Training Institute for Czech government officials offers a training programme for specialists from the ministries. Another valuable source of information for ministries is the OECD handbook 'Managing Public Expenditure for Transition Economies'. It was translated in Czech and is used as a reference book (more about these capacity building activities are described in chapter 4).

## **1.8 Further steps to be taken**

In recent years major improvements have taken place with regard to budget preparation, in particular the introduction of a medium term expenditure framework and programme budgeting. So far there has not been a reform that focused on the execution phase of the budget process. It was only recently that a PHARE twinning project was set up with the French (and Portuguese) Ministry of Finance to reform the State Treasury system.

At present, the Czech National Bank still plays a significant role in the Treasury function, working in close cooperation with the MoF (as in the old regime). The Czech Republic inherited a relatively good system of controlling expenditure so there was no urgent need for reform. However, this system is now inhibiting the further progress towards programme budgeting. The central bank accounts provide information on the basis of economic classification, but they do not give programme information to monitor execution. Moreover, the information flow on what is actually spent is slow, which makes it difficult to manage the flow of funds. Part of the Treasury project will be an integrated budget information system for budget preparation and execution. At present there are 8 different information systems. For instance, there is a separate system for public investments on a multi-year basis and in the past some ministries have bought a new information system for their own budget chapters. In the PHARE project a comprehensive State Treasury system will be built that will be supported by IT investments. According to the Czech National Bank it would be better to modernize the present system instead of building a total new State Treasury system.

## 2 The Czech Republic: process of budgetary reform

### 2.1 Importance of political commitment

The Czech Republic has had the most reform minded government in the early 1990s. At that time, also the public expected unpleasant reform measures. The government implemented many reforms such as privatization, liberalization of the economy and opening of borders. Because of the relatively good economic situation that developed during the 1990s, there was less need for implementing drastic budget reform measures. Since the late 1990s a Keynesian anti-cyclical policy was followed, resulting in increased government expenditure and rising budget deficits. International organizations advised the CR on what measures to take to create sustainable public finances, but it was difficult to reach political consensus on the main issues: health care and pension reform. According to one of the interviewed officials of the Central Bank, the biggest problem in the CR is the *management* of budget reform and not the *content* of reform: how to implement it without losing the essential things.

At present, the political parties have accepted that structural reforms are needed and also the public is aware of this now. The political willingness to implement painful reform measures has been influenced by external pressure from international organizations such as the EU, IMF, OECD and WB. Every study that has been conducted by these international organizations has given support to the national experts who were promoting change. The Minister of Finance is trying to use the external pressure from the Ecofin as well as the strong support from the IMF. In particular EU accession provides strong external pressure to control government expenditure and reduce the deficit. For the EU, these are not only recommendations, but requirements to comply with the Maastricht criteria.

### 2.2 Sense of urgency

The Czech Republic has always been quite developed with good social welfare and health care systems. The population did not feel much sense of urgency to support budget reform measures. As someone from the Central Bank said, maybe it would have been better to have a deep crisis at the beginning of the transition period. A deeper crisis seems to provide more incentives for radical changes (like in the Slovak Republic). However, in recent years public support for budget reform has increased in the Czech Republic. Now

everyone knows that reform is necessary to comply with the EU criteria. The newspapers write about it everyday and the people may understand it better. The majority of the media is in support of fiscal consolidation and recognizes the need to bring down the deficit. There is some public consensus arising that “we cannot make the debt higher for the next generations”. In addition to the external pressure from the EU, there is a strong internal pressure for reform from the Czech private sector (e.g. employers union, chamber of commerce) that wants to adopt EU accession requirements as soon as possible.

Moreover, the people in the CR increasingly begin to see the benefits of budgetary reforms in other countries. In particular they look at the developments in the Slovak Republic that is very similar to the CR in size, culture and historical background. The recent experiences of this country have motivated the Czech population to support budgetary reforms. At present, the CR is lagging behind, while it’s initial position was good and, as one of the interviewed officials said, a healthy rivalry still exists between both countries.

### **2.3 Gradual reform**

The basic philosophy of reform in the Czech Republic is gradual, based on consensus and not a “big shock” approach (like in the Slovak Republic). In general, if something works the CR will apply the reforms, but it does not immediately implement radical measures. For instance, the government is looking at the introduction of a performance orientation and introducing flexible wages and other incentives, like in the New Zealand reforms, but “it plays it safe and does not want to be a laboratory for new experiments”.

### **2.4 Economic Expert Group**

The Minister of Finance – who is very young (33) and not an economist himself – has surrounded himself by (young) economic experts (from financial institutes, banks and university). Some of these experts work as a full time staff member at the MoF and others are consulted on a regular basis. This economic expert group is not politically linked. Politicians differ to what degree reforms are needed but all agree with the direction of reform. The Czech population has more trust in experts than in politicians, as someone said in the interviews. In the first stage of the budget reform the economic expert group consisted of 3 internal staff of the MoF and 6-7 (unpaid) external experts. They had some brainstorming sessions and then proposed their ideas to the politicians. Usually their ideas were accepted so it worked quite successfully.

The second stage of the budget reform has only recently started and is focused on two structural issues: pension and health care reform. The intention is to

use the same philosophy with independent expert groups that will prepare different options for reform of which they will recommend one. Outside the expert group there is a political steering group consisting of both government and opposition parties. This steering group provides political legitimacy to the expert group and also has the function “to keep away the politicians”. The independent expert group not only brings in expertise but it also has the advantage that even if there is a change in government (as at present), the expert group will continue.

The expert group on pension reform is chaired by a senior official of the Central Bank (it is of key importance to choose the right person for this position). The chairman of this expert group does not see pension reform as a one party issue and he deliberately involves the opposition as well. Pension reform will take a long time before the benefits become visible. Therefore the idea is to agree on the basis of consensus instead of arguing between political parties about pension reform. “All political parties are in the kitchen so they realize we are not hiding anything.” All figures and information are on the table. Maybe it is a risk and it will take longer, but it also gives better chances of implementing the pension reform successfully, according to the chairman. Communication is also important, to have discussions early in the process, so that the opposition can see that its points and comments are taken seriously. At the end of this year, there will be different scenarios on the table. All this information will be published immediately on external websites that are open to the public to make it all transparent and people will have the opportunity to make comments.

For reform of the health care system the MoF also wanted to work with an expert group, but so far there has not been enough support from the Ministry of Health and the opposition parties. At present there are no strict ceilings for the health care, resulting in overspending. There is a strong lobby in the health care sector, since a lot of money is involved (while for pension reform the beneficiaries are the next generations).

## **2.5 Position of MoF**

Under the socialist regime, the Czech Republic had a sound fiscal policy compared to other Central and Eastern European countries. It had a strong centralized system of financial control (even local government was included), resulting in low budget deficits and a moderate debt level. However, the position of the MoF within government has eroded during the 1990s. The MoF has become less powerful and, as a result, budget discipline has weakened.

In the last two years the position of the MoF has been strengthened again to some extent. The Minister of Finance gets more support from the Prime Minister. The Prime Minister also sees the need to presume the social state for the future and he publicly supports the reforms. Recently, he appointed

the Minister of Finance as Deputy Prime Minister to strengthen his position in the cabinet. At present, the Minister of Finance and the Prime Minister are convinced about the need for budget reform, but progress will depend on the spending Ministers who need to implement concrete reform measures in their own budget chapters.

## **2.6 Project team for reform**

In the Czech Republic, special project teams work on the preparation and implementation of reform measures. For instance, for the implementation of the Treasury reform a separate project department will be set up. This separate project team will consist of about 14 young well educated staff members who are enthusiastic about implementing changes. The project team will only work on the reform and not do any day-to-day work. The other staff in the State Final Account Department will continue their work on the routine matters. Most of them are older and have worked there already for a long time. Often, they are not very much in favour of reform and as someone mentioned, “it would not be realistic to ask them to prepare the reforms”.

## **2.7 Support for reform**

To make progress with budgetary reform it is important not only to have political and public support, but also to gain the support from the organizations that are directly or indirectly affected by the reform. Otherwise, resistance to the reform may arise, leading to continuous postponement of the necessary decisions. For instance, attempts to reform the Treasury function in the Czech Republic have not been very successful so far, despite numerous recommendations of international organizations such as the IMF and WB. It was only recently that a PHARE twinning project was started on Treasury reform. One reason why reform in this area has not been implemented earlier is that the Czech Republic inherited a relatively good system of cash management, so there was no big need for reform. However, two other reasons may have played a role as well and these have to do with vested interests that were not supportive to reform.

First of all, the Czech National Bank will not gain from changing the present system. At the moment, hundreds of employees of the Central Bank work on cash and debt management operations. In general, these people are much better paid than in the state administration, so for them, it would not be very attractive to move to the MoF.

Besides, in the Czech Republic budget management is very much delegated to spending ministries. In the present situation, the possibilities of the MoF to manage cash flows are limited, because it does not control the Treasury function. Spending ministries do not have an interest in making the MoF

more powerful by centralizing the Treasury function. Why would they create more transparency and make all cash flows visible for the MoF? Since the other ministers do not have an incentive to give the Minister of Finance more control on their expenditures, it may take a long time before the Treasury reform will be implemented successfully.



# 3 The Czech Republic: role of capacity building in budgetary reform

## 3.1 Organization of MoF

The first stage of budget reform did not involve any changes in the organization of the Ministry of Finance but, according to various interviewed officials, for the nearby future this will be necessary. At the moment, coordination problems exist between different departments within the MoF. The State Budget Department, State Final Accounts Department, Financial Policies Department, Debt Management Department and EU Funds Department are all under the responsibility of one Deputy Minister, but the Sectoral Departments that deal with the individual budget chapters are under the responsibility of a different Deputy Minister. This makes cooperation within the MoF difficult, since there is no frequent contact with the Sectoral Departments. As one senior official of the MoF said, sometimes it seems as if the Sectoral Departments are more on the side of the line ministries instead of being on the side of the MoF when they push for more money instead of finding savings. Most of the people in the Sectoral Departments are older and for them it is much more difficult to change their way of thinking into a more result oriented approach. It would be easier to manage the Sectoral Departments if they would all be under the same Deputy Minister.

The Minister of Finance decided to have an organizational audit for the Ministry, starting in the autumn of 2004. The consultancy firm that will conduct the audit should come with recommendations on how to reorganize the MoF and reduce the number of its staff. The MoF in the Slovak Republic has done such an organizational audit last year, which resulted in a change of the organizational structure and a reduction of staff by one third. Following the Slovak example, it is the intention to retain the total salary costs at the same level and have less but better paid staff.

## 3.2 Culture and leadership

The Minister of Finance has mentioned a staff reduction of 30%. However, as one of the interviewed persons said, it is important that these are the right 30%. According to him, not all civil servants have the same level of effectiveness. In parts of the ministry the culture is that everyone works on their own. Some departments have offices all over the building and the managers do not have their people around them. There is not always a clear awareness that the civil servant is there for the minister. Not all parts of the MoF have

a strong management but, as was mentioned in the interviews, “it is of crucial importance to know why you are doing the things you do and having a strategy where you want to go”. Without a strong leadership with a clear vision, you cannot go anywhere. “Many officials in the ministry work very hard, but unfortunately not always in the right direction.” Young, motivated and highly qualified people come in, but when there is a lack of leadership, they may get disappointed and leave again.

Besides, political patronage still exists in the ministry. Some people got their job because they knew someone higher in the hierarchy. For political reasons, people can be promoted or demoted, since there is no formal system of appraisal for employees. If you know the right persons, you can get things done in the ministry. The new civil service reform act, which will mean an end to political patronage, has been approved, but implementation is getting postponed (now it is scheduled for 2006-2007).

### **3.3 Capacity building at the MoF**

Within the MoF, a distinction can be made between two groups and there is a big gap between them. On the one hand, there is a group of young people (around 30) who are well educated, speak English, enjoy work and like the opportunities to travel (for various international working groups). On the other hand, there is a big group of older people (50 and above) in the MoF. They used to work in the former socialist system, did not have opportunities to learn foreign languages, did not go to international working groups and were not obliged to read international public finance literature.

Since there was a lack of capacity in modern economics in the 1990s, the MoF started to recruit students that had just left university. Most of them had studied for some time abroad and learned foreign languages. In the early 1990s many studied in the US, but in the recent pre-accession period, students went more often to EU countries, making use of the Erasmus exchange programme. At present, most advisors to the Minister are only 25-30 years old (and also the politicians are young: the Minister himself is 33, one of the Deputy Ministers is 31 and the new Prime Minister is also only 33). Young people can make fast careers in the Czech bureaucracy. However, as someone said, maybe the young people should first learn more themselves. They need more experience to become good managers. For instance, they often find it difficult to delegate. Sometimes it can be difficult for young people to be accepted by older staff as their bosses, however, this also very much depends on the person's personality.

The young people that work in the MoF are very good, but from the perspective of capacity building the situation is vulnerable, since progress to a large extent depends on these individuals. “If they leave, it means that the ministry is two steps back again”. For instance, 4 out of 10 people from the

original group that was part of a recent MATRA technical assistance project have left now. At present, the best people are recruited by the European Commission to work in Brussels. The state administration is missing mid-career people (between 35 and 50), which is another reason why young people have a fast career.

For the older people it has been much more difficult to adopt different working methods and learn new things. Some of the older generation have made the change and succeeded, but most of them lack the motivation. For them it is difficult to change their behaviour, since they have been raised in the old system, where “average was the best” and where they have learned not to be visible. In the first half of the 1990s the young people were not yet in the MoF (they were still students). At that time, the older generation had opportunities to learn foreign languages and to educate themselves at international institutions (such as the IMF) and Ministries of Finance in other countries. There were opportunities for them, but not all people were enthusiastic. Some were just “surviving until their pension” and it would not make their lives easier to go to Washington, learn English and leave your family for some time.

Some senior managers of the Czech state administration went to the private sector in the early 1990s. They had a network that was interesting for the private sector (even if it consisted of people from the former regime). Moreover, in 1990 it was difficult to start a business, because there was a lack of capital. The only people who had capital at that time were the ones who already had it from the old system. As someone said, “In the first years, the private sector was built on capital from the past”.

### **3.4 Capacity building in spending ministries**

The line ministries have to develop their own capacity. In many cases they have received support from EU technical assistance projects. Different methods have been used to strengthen the institutions with different results. Under the PHARE programme there have been many twinning projects. They provide useful input to the Czech ministries that can learn from the experiences of other countries. However, the disadvantage of twinning projects is that it puts a lot of emphasis on short term experts coming in and giving presentations. These experts tend to give more general background information while the Czech organizations need more specific things. Moreover, the CR should build on its own foundations and not simply copy things from other EU countries, as one pre-accession adviser said, “Short term experts can tell 2 or 3 times how it is done in their countries, but they do not know the local circumstances”. Long term experts, such as pre-accession advisers, can be useful, but often they are more managers than experts. Sometimes study tours can be more effective than trainings. In particular it has been very useful when the study tour included side-by-side working on an ordinary job.

Czech officials have learned a lot from their counterparts in other countries on how to deal with the same practical issues. Also workshops in which real life situations are simulated have been very effective. “People have learned more about new concepts when they were using it in practical exercises than when they only listened to theory”.

### 3.5 Recruitment of staff

The average age in the Ministry of Finance is high (between 45 and 55), which is a common problem of the state administration in the CR. The salaries are relatively low compared to the private sector, which makes it difficult to attract well qualified young people. For instance, in Prague a good accountant can earn multiples of what can be offered by a ministry. Some secretaries in the private sector earn more than PhDs in the MoF. Also the Central Bank is able to pay better than the ministries, which makes it easier to recruit qualified staff. Besides, the social prestige of a government job is not high. However, various interviewed officials mentioned that the situation is better now than in the past. In the first half of the 1990s, most economists and lawyers were absorbed by the financial sector, while at present more people are coming to the MoF. It can offer opportunities to work with international organizations, the wages have improved somewhat and for some people the stability of a government job is also attractive.

There are big differences within the Czech state administration in attractiveness of jobs. In general, the MoF has less difficulty in attracting good and motivated people than most other ministries. As one senior official of the MoF said, “the attractiveness very much depends on the agenda you can offer them”. Departments that can provide access to international organizations can be quite attractive for young people. Therefore, it is not a surprise that the Financial Policies Department has more young people in their staff than for instance the State Budget Department or State Final Account Department.

The Financial Policies Department of the MoF is successful in hiring well educated young people, because it has good relationships with international organizations (e.g. the EU, IMF, OECD) and the staff is awarded the opportunity to go abroad. The Financial Policies Department was established in 1990 and is responsible for macroeconomic forecasting and general fiscal policy. In the early 1990s the Department started with only 2 Divisions: macroeconomic analysis and fiscal projections. In the mid-1990s the Public Finance Statistics Division was established, in 2001 the Fiscal Policy Division and in 2003 the Policy Coordination Division that deals with the Cohesion Fund and structural issues such as the labour market, health care etc. The FPD started with 6 people, now it has 35. The main expansion was in the last 5 years, all by recruiting external people. In the early 1990s also older people were recruited, but in the last 8 years it has only been young people who had

just left university. Of the present staff, 18 are below 30. The 3 new Divisions are exclusively young people. This is typical for other new Departments in the Ministry as well, for instance in the EU Integration Department and Tax Policy Department (in general it is mostly young people that are dealing with international organizations). An exception is the Financial Control Department, which is also new, but does not have many young people. Maybe it is not so attractive to work there or financial control experts prefer to work in private accounting firms.

The wage structure in the MoF is based on seniority, although some flexibility in payment is allowed. Since the payment policy is decentralized to the level of Directors, differences exist within the Ministry. The managers decide to what extent the flexible system is used. In some departments, the flexible part is distributed flat, but others work with an incentive structure. For young people in high positions the flexible part of their income provides a possibility to earn more. For instance in the Financial Policies Department, it is possible to have 50% fixed salary and 50% related to performance (this depends on the person). However, it has been decided that the maximum flexible component will be reduced to 20% after criticism from the EU and OECD that the state administration should be more neutral. The present remuneration system could create too much dependency on the (political) bosses for the payment of the flexible part. These comments should be seen in the perspective that in the Czech Republic a change of government not only leads to new (Deputy) Ministers but that it may also lead to a change of Directors.

### **3.6 Trainings in public expenditure management**

In the period 1998-2002 the World Bank provided assistance to the Czech Republic to build institutional capacity in modern public finance management. It has contributed to improvements in the skills of budget analysts from the Ministry of Finance and the spending ministries. The World Bank activities were focused on those areas that the MoF perceived as being in need of strengthening and included medium term and performance oriented budgeting, treasury functions and liability and fiscal risk management. The WB conducted studies that were used at seminars and that became the benchmark for the preparation of further capacity development in a given area. The studies also draw attention to potential other relevant papers and they provided a group of WB experts, which could be contacted by Czech officials with questions and which could participate in follow-up project teams.

The World Bank also organized a training programme on modern public finance management. The trainings were prepared by the Netherlands Economic Institute (NEI) together with the Public Finance School of the Dutch Ministry of Finance. The training programme consisted of 2 two day and

4 five day training courses focused on medium term budgeting, programme and performance oriented budgeting and audit in public administration. The two day seminars were meant for senior officials of the central government. Altogether, more than thirty participants from the level of deputy minister or heads of offices of central bodies took part in them, including several top level representatives. The main purpose of these seminars was to create a platform for discussion on necessity and direction of further budget reform steps. The trainings for high level managers from the state administration have improved their understanding of the nature of fiscal risks and their impact on fiscal stability and of the recent trends in EU countries with regard to budget reform to deal with fiscal challenges. Nevertheless, insufficient potential support from the government's top leadership is still considered as one of the risk factors for the preparation and implementation of budget reform measures. The attention of the public managers was also drawn to the need to change the attitudes and behaviour of those who prepare and manage budgets to make them support new approaches.

In the five day training courses on public expenditure management more than 120 people participated. Besides the MoF staff, there were representatives of all ministries and central bodies. Most of them were directors of departments or heads of units responsible for the budget chapter of the particular ministry. Also lecturers and researchers of the Faculty of Finance and Accounting of the Prague School of Economics and Economic and Administrative Faculty of the Masaryk University as well as staff members of the Supreme Audit Office were present. Given the great interest of potential participants, four training courses were organized instead of the three originally planned. The trainings were also focused on medium term budgeting, programme and performance oriented budgeting and audit in public administration. These topics were discussed with regard to the present situation and perspectives of reform in the Czech Republic, in confrontation with the experiences of the Netherlands and other countries that have made progress on budget reform. The lecturers combined presentations with discussion, case studies and simulations. The participants worked in groups while conducting analysis, finding solutions for practical problems and presenting the results. The training of staff members of both the MoF and line ministries was of considerable benefit. Parts of the knowledge obtained could be directly used when the new state budget (including the medium term budget outlook) was drafted. As one official of the MoF said, many people remember the training and still speak about it. The participants of the training courses started to think in a different way with new terminology, although many of them have already worked for a long time in the MoF. Some of the older people also want to know the things that their young colleagues have learned at the university.

Recently new trainings on public expenditure management have been organized for staff of the Ministry of Finance and the Ministry of the Interior.

About 80-100 people from different Departments of the MoF were trained. There were 2 levels: a 3-4 days training for middle management (directors and heads) and a 5-6 days training for operational staff who are responsible for budget chapters. The OECD handbook on transition economies was used in the training. Some people were open to new approaches, others were not, but most of them assessed the training positively. They could use what they learned when they advise directors and ministers on decisions that are related to the budget. They now know better how to analyze the budget chapters and they better understand what additional information is needed in order to make a good assessment of the proposals.

Giving the training courses was not so easy as the trainers thought in the beginning. For the lecturers of the university, it was very difficult to make it practical and connect it to the daily work practice of the civil servants. The training was therefore also useful for the lecturers themselves, for their work in the university. They learned about the practical needs of the ministries. This is useful because they are the ones who teach the new public administration students who will be the future civil servants. One professor even said that he wanted to write a new book, based on his experiences during the training.

For the future, it would be good to make the training more oriented to individual needs and divide people in similar groups based on their work (for instance groups of MoF staff and their counterparts of line ministry together). It is also very important that the trainings are tailor made. It should not focus on theory, but on practical knowledge how to do it. Another lesson that was learned is to organize the training next time outside the MoF building. For some participants it was difficult to leave their work and they sometimes went back to their offices during the training. Other ministries are also interested in this kind of trainings. The idea is that some of the MoF people will train other ministries (the 'train-the-trainer' concept).

In 2002, a training institute for Czech government officials was established. In the past systematic training was lacking and it very much depended on initiatives of individuals. The institute provides a wide range of general training courses, most of them related to the EU. Besides trainings that are focused on obtaining knowledge, it also offers trainings that are oriented on the development of personal skills. Examples of the different training courses are "Introduction course for new employees of the state administration", "Decision making processes in EU", "European Monetary Union", "EU accession and its effects on the Czech state administration", "Introduction to EU law", "EU recruitment", "Intercultural cooperation", "Organization of manager's work", "Communication for middle management", "Negotiation and problem solving", "Team leadership for middle management", "Stress management" and "Assertiveness for state employees". The training institute is not particularly focused on public finance management. However,

there is a demand for trainings in this area and the institute has the possibility to use external trainers from the MoF and the Prague University of Economics. At present, it is not yet clear how it will be worked out.

### **3.7 OECD handbook**

In 2001 the OECD released a publication on modern public expenditure management: “Managing Public Expenditure: A Reference Book for Transition Countries (by R. Allen and D. Tommasi). The Czech Ministry of Finance asked the OECD for permission to translate it into Czech. Grants were used to pay for the translation and printing of the book, which was distributed on a non-commercial basis within the MoF, to other ministries, universities and other interested organizations in September 2002. The book contributed to the development of capacity on public expenditure management within the Czech state administration. Ministerial staff was given a comprehensive publication summarizing the information that formerly could only be obtained through partial materials, trainings and practice. The publication was also very useful as a textbook for universities. The publication or selected chapters were also used as study material for trainings on public expenditure management. The fact that the translation was not commissioned to professional translators but that it was done by a group of professionals from the Ministry of Finance and the Supreme Audit Office was also very valuable. Specification of a consistent terminology and compilation of a glossary was of considerable benefit too.

### **3.8 Capacity building at the Czech National Bank**

In the early 1990s a lot of staff of the Czech National Bank were above 50 and did not know how a central bank should work. In the beginning there were many language problems. Only a few spoke English, so interpreters were always needed. The younger people at that time (below 30) were still flexible enough to learn new things, mainly in practice but also through (advanced) courses at the IMF in Washington. For this first generation it was learning-by-doing. Later, new people came in from universities who had studied some time abroad. For the Central Bank it is not a problem to attract good students, because it can offer good salaries (better than the government).

In 1998 there was a big reorganization at the Central Bank and the number of staff was reduced by 15% (almost all of them were close to retirement). The CNB has less staff now, but good quality. At present, the average age is very young. For instance, out of the 50 staff members that work on monetary policy, half of them are 30 or below, also in high positions (even one of the Executive Directors on the Board is only 29). However, having a lot of young people in the organization can be a disadvantage as well, as one senior bank official said. They miss experience and can be too radical with reforms. “They have their knowledge from textbooks, but miss real life experience”.

The CNB staff regularly meets officials from the central banks of other (old and new) EU member states in seminars, research projects and the ECB working groups.

### **3.9 Capacity building at the Supreme Audit Office**

Staff members of the Czech Supreme Audit Office (SAO) receive initial training and they take part in specific advance courses to acquire the necessary knowledge. A major priority of training is the internationally recognized auditing standards and changes in techniques and practices related to the EU accession. For training programmes, courses and educational seminars, the SAO has its own facility that can accommodate 70 people. The relations with supreme audit institutions in other countries and exchange of experience and information have raised the standard of audit work in the Czech Republic. The SAO is taking an active part in international seminars and expert meetings and it has organized several of these to date.

A recent PHARE twinning project in the area of external financial control, which was implemented in 2002-2003, has been of particular importance for the strengthening of the SAO in the Czech Republic. In the project, twinning relations were established with the German Supreme Audit Institution (Bundesrechnungshof). Substantial support has also been received from the European Court of Auditors, the State Court of Audit of Hesse, the National Audit Office of Great Britain and the German Technical Assistance Agency (Deutsche Gesellschaft für Technische Zusammenarbeit).

The overall objective of the twinning project was to strengthen external financial control functions of the SAO to the level of the Supreme Audit Institutions of the EU member states. Most important for this were the pilots on financial and performance audits that were supported by German and British short term experts. Additionally, the audit capacity was developed by several intensive seminars, workshops, lectures and direct consultancies. Furthermore, in total 8 study trips were organized to the German Federal Court of Audit, the European Court of Auditors and the National Audit Office in London. The value of the study trips to the participants was obvious. They received the opportunity to see on site the practical work of professionals, who have profound audit experience. This experience was normally not open to them in their own SAO.

The pilots on financial and performance audits were successful concerning improvements in using European standards and training auditors on the job and giving them more self-confidence. The pilot audits were conducted in accordance with the INTOSAI Auditing Standards and the European Implementing Guidelines. The pilot on financial audit has highlighted four key areas, which need to be addressed by the SAO in developing their methodologies and audit approaches. These areas are:

- Risk based approach: the SAO should have a clear audit approach on how to implement a risk based approach and this should extend to the sampling techniques and projection of errors.
- Documentation: the documentation for the first pilot audit was very extensive and thus not always transparent.
- Sampling: similar like risk based approach, the usage of sampling techniques, with respect to non standard quality of accounting statements, were used in a limited scale and this resulted in heavy substantive testing.
- Review process: at present the SAO does not have in place any review processes. The main reason for this is that the SAO auditing standards currently do not permit this activity. However, the SAO has plans to move to the international standards in due course.

The object of the first pilot performance audit was the planning activities of the Ministry of Transport concerning the development of a traffic network in the Czech Republic. As the German Supreme Audit Institution conducted a similar audit on the traffic network in Germany it was possible not only to give proposals for amendments but also to share experience and compare the audit results. The overall conclusion was that this difficult audit was carried out in a highly professional manner with very good results. The object of the second pilot performance audit was selected road construction and renovation programmes all over the Czech Republic. As part of this pilot audit, a special manual was elaborated, giving guidance for auditing projects related to investment in infrastructure.

After 14 months a large number of objectives had been achieved regarding the training of SAO staff, training trainers, elaborating manuals and standards and conducting pilot audits. In general, it was indicated that it is much more difficult for the older staff to develop new auditing skills than for the young people. The interviewed staff of the SAO mentioned that they have very positive experiences with the new young auditors. They are trained in new audit skills when they start working at the SAO. The young graduates have the ability to try new methods, they know how to apply modern IT systems and they are enthusiastic about learning new things. For financial audits a separate unit is created within the SAO, which mainly consists of young people. Also performance audits are to a large extent done by the younger people although this is more mixed. However, young teams lack experience, which can be a disadvantage as well. Sometimes it can create problems, for example when they do not have the proper documentation to support their audit results to make the evidence convincing to external parties.

### 3.10 Technical assistance

In the first years of transition, the IMF and World Bank were very important for the reform agenda in the Czech Republic. The IMF provided a lot of technical assistance in the areas of public expenditure management (for instance on changing the Czech budget classification to GFS) and VAT administration. Besides, it has given assistance in other areas such as monetary management, foreign exchange operations, banking supervision, banking system reform and money and banking statistics. Interviewed officials indicated that the first Czech government was a strong partner for the IMF, since it included many economists who already had studied some literature on western market economies.

Nowadays, the IMF involvement in the CR is limited to the annual Article IV consultations (like in other EU member states). The IMF office in Warsaw will be closed down by the end of 2004. Earlier the IMF offices in the Czech Republic, Hungary and the Baltic States were already closed. The Warsaw IMF office will be transformed into a regional office, dealing with general issues such as the euro and public sector reform across transition countries, and will no longer deal with the country itself.

The World Bank has supported key structural reforms and the modernization of individual sectors (e.g. the energy and telecommunication sectors) through financial and technical assistance. From 1998 onwards, the areas of WB involvement increased with assistance provided mainly through analytical and advisory services. WB assistance has supported the EU accession process, capital and financial market reform, enterprise restructuring and fiscal management, corporate governance, the regulatory framework and pension reform options, with some activities continuing in the energy and environment sectors.

At the end of the 1990s “hidden” deficits emerged, stemming from the huge amount of state guarantees issued for different programmes without putting aside sufficient reserves. In 1998, the Czech government invited the World Bank and the IMF to assist the MoF to analyze the sources of fiscal risks and strengthen the management of contingent liabilities. With the assistance of WB experts a framework for fiscal risk analysis was prepared, which focused on identifying their sources and on better understanding their nature and intensity. The study of the WB analyzed the situation in the CR and highlighted the main risk factors endangering “hidden” deficit increase and pointed to the bottlenecks of the legal and institutional framework for their management. With assistance of the WB, bigger transparency and better medium term predictability of the financial transactions in off-budget systems were successfully achieved. The World Bank contributed very significantly with its work regarding contingent liabilities and fiscal risks to the capacity of budgetary specialists, not only at the MoF but also at line ministries.

In the second half of the 1990s the influence of the EU increased substantially, especially in the last years before accession. The European Commission reviewed the Czech legislation, which led to many recommendations for reform, in particular in the area of financial control. In the preparation for EU accession, many PHARE projects have been implemented, for instance in the area of taxation, customs, capital markets, money laundering and insurance. Technical assistance was also given at local government level, for instance on internal audit for regions and municipalities (a twinning project with the UK). Although not all people that were trained are still working for the state administration, the trainings were very valuable for the strengthening of institutions. Furthermore, it was indicated that the OECD seminars on public finance management have also been important for the direction of budget reform in the Czech Republic.

At present a PHARE twinning project is being implemented on financial control and internal audit. The purpose of the project is to ensure an efficient management, monitoring and control of EU assistance, EU own resources and public funds at central and decentralized levels in compliance with the EU *acquis*. Besides the development of financial control and internal audit mechanisms according to the EU regulations (for the EU and co-financed funds), it also includes the integration of national funds and EU funds in the budget from 2006. The EU funds are now kept separate from the national funds with special financial control mechanisms. The EU requirements involve three different aspects: day-to-day financial management and control systems, systems verification (internal audits) and expenditure verification (checking expenditure on a risk analysis basis).<sup>41</sup> The programme authorities in line ministries are responsible for these control measures, but they have to figure out by themselves how to do it. Moreover, within and between ministries there is no tradition of cooperation and every department works on its own. They receive assistance from twinning projects, but sometimes this only adds to the confusion. They learn things from their twinning partners, but the old EU countries have developed different ways to follow EU regulations. If a Czech official now moves to another ministry, it can create a lot of confusion. As a result, the total picture on financial control is lacking. Therefore, it is important for the CR to build on its own foundation with the minimum change possible.

Another PHARE project that started recently is the reform of the Treasury function. It is a twinning project with the French MoF and also partially involving the Portuguese MoF. The project involves technical assistance and financial support for investments.

41 These requirements are described in art. 438 of the 2001 EU Regulation (items 4, 10, 15).

An area where technical assistance has proven to be very successful is macroeconomic forecasting. The Financial Policies Department of the MoF started with very basic economic modeling in the early 1990s. At that time they had many problems with the quality and timeliness of data. With the support of two technical assistance projects, the macroeconomic projections have been improved in an on-going process. At present, the Department produces quarterly projections. The forecasts are used for budget preparation.

In other areas of public finance management there is less need for technical assistance. For instance, Czech officials are now preparing the implementation of a MTEF without external assistance. They are very much aware of the need to have a medium term framework with hard ceilings and they receive a lot of information from colleagues in international meetings, for instance in meetings with other EU countries and in the Senior Budget Officials working group of the OECD. The Czech officials listen to different opinions from abroad and look for themselves what would fit best in the local circumstances. Cooperation with other EU accession countries seems to be limited.



## 4 The Czech Republic: conclusions and lessons learned

The Czech Republic is performing well on most macroeconomic indicators (economic growth, stability of the financial sector, inflation, foreign direct investment etc.). At present, the focus of most political and public discussion in the Czech Republic is on fiscal consolidation. External pressure (in particular from the EU) has contributed to an increased awareness of politicians and the public of the need to control government expenditure. The Czech government has the intention to join the euro-area around 2009-2010 and therefore aims at a reduction of the budget deficit to 3% of GDP in 2008. The priority of budgetary reform in the Czech Republic is on achieving aggregate fiscal discipline. In particular, this will require structural reforms of the pension and health care systems to bring down the level of government expenditures in these areas. In order to meet the fiscal targets, they will be set in a binding medium term framework that will enforce the aggregate level of expenditures of the state budget and extra budgetary funds within a three year horizon.

In recent years, increasing attention has been given to allocative and operational efficiency. The government set its first steps towards programme budgeting in 2001 with the introduction of a programme classification for capital expenditure. In 2003 this has been extended to all expenditures, although it is still on a voluntary basis. Spending ministries are requested to link their budgets to programmes and they now put in more effort to think about objectives, activities, efficiency and effectiveness of their budget proposals. The introduction of programme budgeting is still at an early stage and will need time to be implemented successfully. It not only requires different working methods for budget chapter administrators but also a different attitude towards public expenditure.

Technical assistance has been important for the strengthening of budgetary institutions in the Czech Republic. In particular in the early 1990s there were many visits of external advisors from the IMF and World Bank. Later attention shifted to technical assistance from the EU. The EU accession has significantly contributed to the implementation of reforms in the Czech Republic. The exchange of ideas with colleagues in international meetings (in the EU but also for instance in the OECD) and reading international literature (e.g. the OECD Handbook) has been of crucial importance for the direction of reform in the Czech Republic. It has contributed to the harmonization of Czech public expenditure management with international best practices (e.g. medium term and programme budgeting).

Recruitment of qualified staff is a general capacity constraint for the state administration in the Czech Republic, given that the salaries are relatively low compared to the private sector. However, there are big differences between and within ministries with regard to attractiveness of jobs. In general, the MoF has less difficulty in attracting good and motivated people than most other ministries, in particular departments that have working relationships with international organizations (such as the EU, IMF and OECD). The situation has also improved in comparison to the first half of the 1990s. Retention of good staff is another problem; for instance, the best people are now recruited by the European Commission to come to Brussels.

So far, capacity building activities have mainly taken place at the individual level, in particular through trainings on public expenditure management for officials of both the Ministry of Finance and the spending ministries. As a component of technical assistance projects (mainly twinnings) also workshops, seminars and study tours have taken place.

In the autumn of 2004 an organizational audit will be conducted for the Ministry of Finance. It should provide recommendations for reorganization of the MoF and reduction of its staff. In particular coordination problems exist between Departments that work under different Deputy Ministers. The implementation of the new civil service reform act is expected to give a further contribution to capacity building at the organizational level.

A lesson that could be drawn from the experiences of the Czech Republic is not to copy automatically everything from abroad but look at what the consequences are, since they can have a negative impact on other things. For instance, the fiscal statistics in the old regime were very elaborated. On the basis of the IMF advice, it was all replaced by a new system based on GFS, but a lot of valuable information has been lost during that process. As one of the interviewed officials said, in the beginning of the transition period, the idea was that everything from the former regime was bad and should be abolished. However, it is important to build on your own foundation and realize that it is a process that takes time. In 1990 a relatively efficient working administrative system was inherited. In the years that followed the institutional capacity first became worse before the state administration was redeveloped again and new (and different) capacities were created. The Czech Republic lost certain capacities (for instance with regard to the operational management of the budget, also within line ministries) that it needed again later on. The challenge is how to develop a new system without losing the good things of the old system at the same time.

## 5 Interviews Conducted in the Czech Republic

Ministry of Finance	
Mr. Eduard Janota	I. Deputy Minister of Finance
Ms. Milena Horcicova	Director Financial Policies Department
Ms. Drahomira Vaskova	Deputy Director Financial Policies Department
Mr. Bohdan Hejduk	Director State Budget Department
Mr. Milan Bohac	Director State Final Account Department
Ms. Hana Heidlerova	Director European Integration Department
Mr. Tomas Sedlacek	Adviser to the Deputy Prime Minister and Minister of Finance
Ms. Katerina Helikarova	Previous Adviser to Deputy Minister of Finance
Ms. Drahomira Pexova	Deputy Director of Central Harmonisation Unit for Financial Control
Ms. Jana Stara	Head of Phare unit
Mr. Sean O'Sullivan	Pre-Accession Adviser Ministry of Finance
Czech National Bank	
Mr. Pavel Stepanek	Chief Executive Director, Member of the Board (and previous Deputy Minister)
Mr. Vladimir Bezdek	Adviser to the Bank Board, Economic Research Department
Mr. Ivan Matalik	Director of Fiscal and Structural Analyses Division
Mr. Michal Slavik	Fiscal and Structural Analyses Division
Mr. Tomas Hladek	Executive Director Cash and Payment Systems Department
Mr. Tomas Kvapil	Executive Director Financial Markets Department
Mr. Jiri Pospisil	Adviser
National Audit Office	
Mr. Miroslav Leixner	Director
Ms. Eliska Kadanova	Member of the Office
Ms. Viktorova	
Mr. Jaroslav Broza	
Office of the Government	
Vera Kamenickova	Previous Director Local Government Financing Department
Ministry of Education	
Ms. Jana Peskova	Economic Department

Mr. Jiri Vacek	Economic Department
Ministry of Justice	
Ms. Jana Nemeckova	Head of Economic Department
Mr. Miroslav Brom	Head of Budget Department
Czech Statistical Office	
Ms. Ludmila Vebrova	Head of Government and Financial Accounts Section
IMF	
Mr. Cyrus Sassanpour	Senior Resident Representative of the IMF in Warsaw, Poland

# **Annex B**

## **The Case of Latvia**



# 1 Latvia: background of budgetary reform

## 1.1 Country characteristics

### 1.1.1 Political environment

Latvia is a parliamentary republic. This system was initially established on 18 November 1918 and re-established by the Declaration of the Renewal of the Independence of the Republic of Latvia of 4 May 1990 and the 21 August 1991 declaration proclaiming the authority of the *Satversme* (Constitution).

The highest legislative body in Latvia is the one chamber *Saeima* (Parliament), whose 100 deputies are elected for three years in direct, proportionally representative elections. The Saeima in turn elects the president. The Government cabinet is nominated by the largest coalition party and approved by the parliament.

Generally the Government consists of coalitions of many parties. The number of politically influential parties with representation in the parliament has been changing, however, with every new election. This is reflected in the high turnover in prime ministers and also ministers of finance. Since restoration of independence there have been 11 prime ministers and 14 ministers of finance.

Although Latvian governments have changed often remarkably, fiscal discipline has been carefully preserved. This importance of public institutions in achieving fiscal discipline was highlighted in a 2003 study<sup>42</sup> exploring the linkage between the institutional design of budget processes and aggregate fiscal performance in ten countries in Central and Eastern Europe. The main conclusion is that “*budget institutions indeed have had a significant effect on the capability of governments in CEEC to gain control over public finances during transition. Countries having institutional structures that are more conducive to strengthen coordination and cooperation in budget decision-making have been associated with lower budget deficits and reduced debt levels.*” Evidently, the right institutions have been in place to maintain fiscal discipline. On the other hand, this case study will argue that the same institutions have slowed down advances in allocative and operational efficiency.

42 Holger Gleich, *Budget institutions and fiscal performance in Central and East European Countries*, European Central Bank Working Paper Series, No. 215, February 2003.

## 1.1.2 Macroeconomic and fiscal developments and prospects

After re-enactment of independence in 1991, Latvia embarked on an ambitious economic stabilization and reform programme supported by the International Financial Institutions. Main aims included the stabilization of the economy, privatization, deregulation, currency reform, private sector development and the creation of market institutions. Latvia's macroeconomic performance reveals two distinct phases:<sup>43</sup>

- 1 The initial transition from 1991 to 1995, which showed a sharp decrease in output, a fast decrease in employment, and a large increase in unemployment.
- 2 The recovery since 1996, which is evidenced by an increase in output (though still lower than in 1992), substantial productivity growth, continuation of employment, and a net decrease in employment participation.

The structural reforms and EU integration have facilitated economic growth. Latvia has become one of the fastest growing European countries. Average annual growth of Latvian gross domestic product (GDP) in the period 1996 to 2003 was 6%. In 2003, the real growth of Latvia's GDP reached even 7.5%. Inflation has been contained due to a firm price stability objective. The currency, Lats, has been pegged to the SDR at a fixed rate since 1994, and has successfully contributed to the disinflation process in Latvia. Inflation decreased from 17.6% in 1996 to 2.9 % in 2003. Latvia intends to change the current lats peg from the SDR currency basket to the EURO in 2005 and plans to adopt the EURO in 2008, after fulfilment of the convergence criteria. Despite the economic success and favourable prospects, unemployment has remained a huge problem in Latvia. (see table 1.1).

**Table 2 Basic economic and fiscal data on Latvia**

Basic data	1996	1997	1998	1999	2000	2001	2002	2003
Population (average)	2469.5	2444.9	2420.8	2399.2	2381.7	2364.3	2345.8	2331.5
GDP (current, mln EURO)	4 458.2	5 422.9	5 895.6	6758.8	8367.3	9179.9	9761.7	9802.3
Real GDP growth (%)	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5
CPI (year average)	17.6	8.4	4.7	2.4	2.6	2.5	1.9	2.9
EUR/Lats exchange rate	-	-	-	0.625	0.560	0.563	0.583	0.645
Unemployment rate (%)	7.2	7.0	9.2	9.1	7.8	7.7	8.5	8.6
Current account (mln Lats)	-154.2	-201.1	-380.4	-379.5	-301.0	-460.6	-396.1	-542.9
General Government +/- (mln Lats)			10.3	-143.4	-120.7	-104.2	-148.0	-105.1
Central Government debt (mln Lats)			372.6	510.7	570.9	712.9	756.1	846.3
Consolidated Government Finance*								
Revenue					34.6	32.8	33.0	33.4
Expenditure and net lending					37.6	34.9	35.4	35.0
Fiscal balance					-3.0	-2.0	-2.4	-1.6
Gross government debt					12.2	13.8	13.3	13.4

(Sources: Central Statistical Bureau of Latvia, Bank of Latvia, \* International Monetary Fund)

43 World Bank, *Latvia – The Quest for Jobs and Growth*, World Bank Country Economic Memorandum, Vol. 1: Policy Briefing, January 2004.

The fiscal framework has been strongly governed by Latvia's agreement with the IMF to maintain fiscal discipline. This PFM objective has received strong political commitment from all Governments irrespective its composition. The fiscal deficit decreased from -4% of GDP in 1994 to a surplus of 3.3% in 1997, The Russian crisis in 1998 led to an increase of the deficit to -3.3% in 2000, but decreased towards -1.6% in 2003.<sup>44</sup> As a result of Latvia's restrictive fiscal policy, the government debt is very low and is even one of the lowest among the new EU member states.

### 1.1.3 The budgetary process

The Law on Budget and Financial Management governs the budget process. This law specifies the detailed budget cycle, the procedures for the formulation, approval and implementation of the State budget and local government budgets, and the responsibilities in the budget process.

The flexibility in management of the budget during budget execution is determined by legislation as well. Line ministries cannot easily switch resources between different (economic) expenditure categories and between (sub-) programmes. They can only make changes within the agreed budget of a certain category, such as a switch between monthly expenditures of the same category if the Ministry of Finance has approved it. It will also require approval by the *Saeima* through supplementary budgets if it involves changes between (sub-) programmes.

## 1.2 Starting points for Public Finance Management Reform

### 1.2.1 Public Finance Management Reform Actors in Latvia

Even though many public institutions in Latvia and departments of the Ministry of Finance have participated in the reform efforts, the focus of this case study has only been on a number of crucial actors in public finance management reform. To set the stage of describing the content of PFM reforms, figure 1 illustrates those key actors.

In Latvia PFM reform in the sphere of budget planning and budget preparation has primarily been promoted by a new department in the State Chancellery, i.e. the Policy Coordination department (PCD) that was created in the fall of 2000, in response to the recommendations in an influential report on Public Administration Reform. The Policy Coordination department is formally responsible for leading the government's priority setting process, and coordinating all products for Cabinet's review and approval. It has played a lead role in introducing and coordinating strategic planning within pilot line ministries, as first being the Ministry of Agriculture, followed by the Ministry of Economy, the Ministry of Finance and the Ministry of Culture.

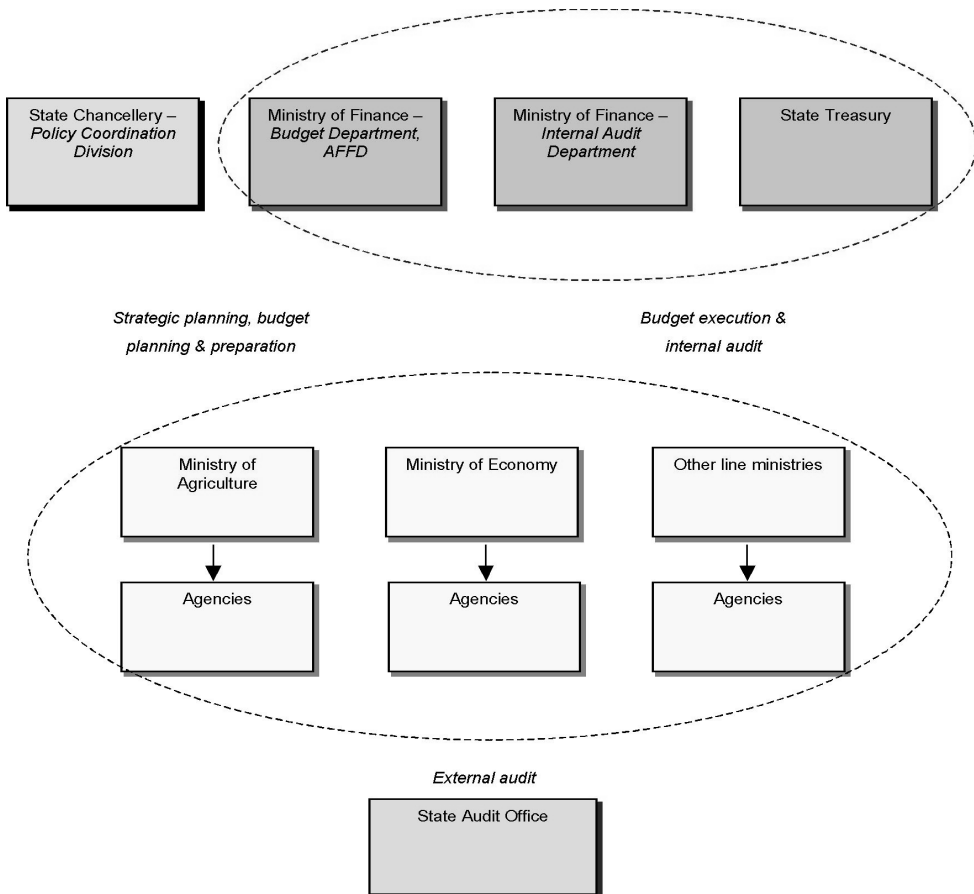
<sup>44</sup> Celestin Monga, Latvia's Monetary Options in the Medium Term, Fiscal and Monetary Challenges of EU Membership, World Bank Policy Research Working Paper 3307, May 2004.

The Economic Analysis and Fiscal Forecasting department (EAFFD) has promoted the strengthening of the macro and fiscal framework

The State Treasury and the Internal Audit Department of the Ministry of Finance have encouraged budget execution and audit reforms. The Treasury of Latvia, *Latvijas Republikas Valsts Kase*, is the key institution responsible for budget execution and management of state debt. It exists already since 1919. In its contemporary form it exists since 1997 as separate entity under the direct supervision of the Ministry of Finance. The Internal Audit department was established in 1999 in the Ministry of Finance with the responsibility for developing and coordinating internal audits in line ministries.

Both in budget preparation and budget execution the Budget department has played a role, though interviews indicated that it has not been a major initiator of budget reforms. Nonetheless the Budget department has been a constructive participant cooperating with the other institutions.

The State Audit Office was established in 1993 and has to a certain extent developed itself outside the PFM reform agenda of the Government.



## 1.2.2 External and Internal Pressure for PFM Reform

EU Accession, the IMF and World Bank programmes, as well as WTO and NATO have “unquestionably influenced policymaking because the conditions associated with membership provided targets that helped policy makers reach consensus on launching and sustaining politically difficult reforms designed to liberalize the economy and trade.”<sup>45</sup>

The standby arrangement with the IMF in 1992 received strong political commitment and the IMF contributed since then significantly to fiscal discipline in Latvia. Moreover, the ambition to join the EU in 2004 and the planned aspiration to join EMU in 2008 has contributed to achieving fiscal discipline.

The negotiations on Chapter 28 of the *acquis communautaire* “Financial control” promoted improvements in budget execution, internal control, internal and external audit. The negotiations opened in the 1<sup>st</sup> half of 2001 and ended in December 2002, though provisionally already in the second half of 2001.<sup>46</sup>

The World Bank took a promoting role in key areas not explicitly covered by the *acquis communautaire*. Its Structural Adjustment Loans included also PFM support in the area of budget planning and budget preparation and support to Public Administration Reform. The present Country’s Assistance Strategy (CAS) is focussed on existing support for social sector reforms. Moreover, support is provided in building a knowledge economy and enhancing local development planning capacity in major cities. World Bank’s sectoral oriented projects, such as the Social welfare project, resulted in a professional policymaking apparatus in the areas of social welfare and social insurance and have supported the Government’s ambitious new three-pillar pension system.

Despite the external anchors, the recognition of the importance of good budget execution procedures and strengthening of internal control and audit has come from within the Latvian apparatus. Latvia has set its own agenda and started already with making improvements by strengthening the State Treasury and setting up internal audit in all line ministries before the *acquis communautaire* negotiations.

45 World Bank, *Latvia – The Quest for Jobs and Growth*, World Bank Country Economic Memorandum, Vol. 1: Policy Briefing, January 2004, p. 7.

46 European Commission, *Comprehensive monitoring report on Latvia’s preparations for membership*, 2003. See also Position Paper of the Republic of Latvia Chapter 28: “Financial Control”.

## 1.3 Key reforms efforts and achievements

### 1.3.1 Sequencing

Whilst fiscal discipline has been on the forefront of the PFM agenda, in operational terms the immediate focus has been first of all on improving budget execution. In Latvia devolution of financial management responsibilities within the Government preceded development of proper internal controls and financial accountability mechanisms at lower levels. Therefore there was an urge to set up a separate State Treasury, which allowed halting the decentralized budget execution where line ministries had own bank accounts.

The major impetus was the desire to have timely and actual information on how money has been spent. This as well as the establishment of internal audit was already promoted before the EU insisted on making changes. In fact, the EU urged for a separate system for their own pre-accession funds, but Latvia asserted for one system for both national and EU funds. Since financial management skills have been built special payment authorities were not needed.

Many achievements have also been made in economic and fiscal forecasting and Latvia has considered a rather conservative approach to fiscal forecasting which contributed to the aim of maintaining aggregate fiscal control.

In the area of budget planning and budget preparation efforts must be seen in the broader perspective of public administration reform aimed at making the whole institutional structure and its institutions more efficient. Already in 1995, a Public Administration Reform programme was approved by the cabinet, which envisaged a system “*which would efficiently and equitably carry out the functions entrusted to it by society*”. However, the issue of efficiency was not on the top of the agenda.<sup>47</sup>

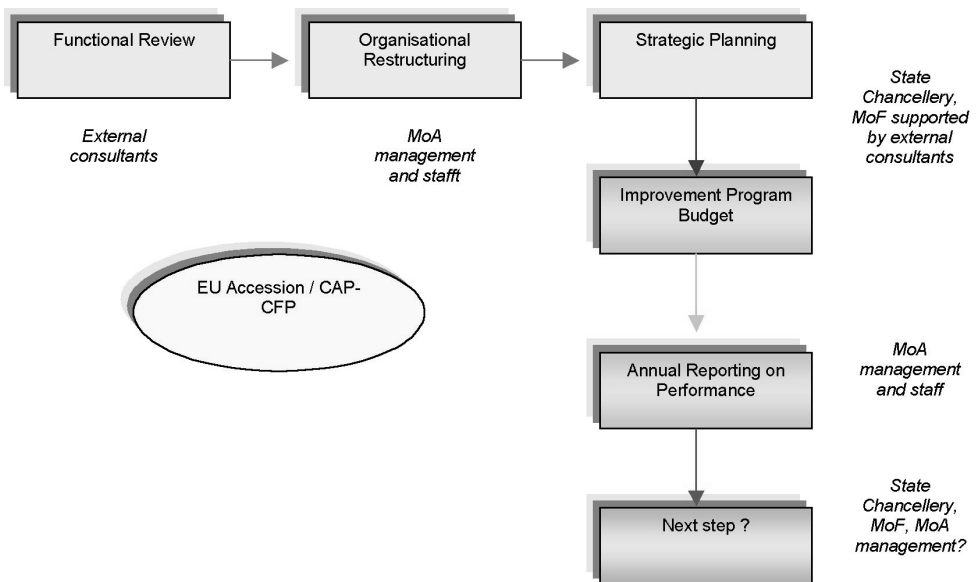
Programme budgeting was introduced in all Ministries in 1996, at very short notice, and with hardly any training or assistance on the processes of programme budgeting. The main aim was to overcome incrementalism in the budgeting process. Whilst the budget has appeared to be in programmatic format over the last few years, many of the programme categories have been presented as simply input category items. Partly the lack of clearly articulated sectoral goals on a medium term basis contributed to this. In 2003 additional efforts were made to strengthen programme budgeting by prescribing new guidelines for performance measurement.

There were also separate other initiatives aimed at promoting priority setting and overcoming excessive emphasis upon incremental budgeting. For that reason horizontal and targeted vertical reviews were conducted followed by specific sectoral public expenditure reviews. More institutions

<sup>47</sup> Iveta Reinholde, Performance evaluation in Latvian public administration, p. 2, 2000.

were involved, though politics remained less prominent at this stage of the budget cycle. Many efforts have been introduced on a stop-and-go basis and only in one case, the Ministry of Agriculture; a more systematic approach seems to have developed. This was primarily promoted by the own internal management of that Ministry, though supported by the State Chancellery and external consultants, which had a clear vision on the challenges forthcoming from the EU accession (see figure 1.2).

Recent efforts to improve budget planning and preparation include the pilot testing of strategic planning. The Ministry of Agriculture has been the first line ministry that has developed a medium term strategy that includes its redefined programme budget structure. After programme budgeting, it has been the first serious attempt to link planning with budgeting.



In 2003 efforts were made to seriously go to a form of zero base budgeting by prescribing a wide range of centralized and decentralized programme reviews in order to find savings to accommodate the expenditure decisions of a new Cabinet. Interviews indicated that this zero base budgeting concept did not have much result, other than proving to be an instrument for higher requests and resulting in massive paper work.

Some optimism came up during the preparation of the Budget for 2004. After many recommendations from international financial institutions and various experts working on technical assistance projects, the Government adopted a decision to avoid earmarking of revenues (except in the area of

social security). The deal was that the financing allocated for the special budgets expenditures that would be included in the central government budget would be maintained at least at the previous year's level. This step forward has been considered to be a huge victory over sectoral interests and increased the flexibility of resource planning and therefore is seen as a step forward in reducing incrementalism in the budgeting process.

Since coalition governments in Latvia are short lived, budget planning and preparation have been seen as a tool to accommodate short term requests. This short term horizon, did not allow developing "stronger budgets", improving analysis and introducing feasible performance measurement. Also it did not allow seeing policy making as making policy changes to improve the quality of rules, regulations and systems. The fact that external anchors did not and still do not have firm requirements in the area of budget planning and preparation other than an aggregate fiscal target, there was and still is no impetus, except for the unconditional efforts of the World Bank and other donors. Allocative and operational efficiency is therefore still a major topic on the PFM reform agenda where public officials are trying to cope with the political reality.

The following sections will touch upon more details on the various PFM reforms.

### 1.3.2 Treasury

The State Treasury was re-established shortly after the restoration of independence of Latvia in 1991. It was established in 1997 as a separate institution, though remaining under the responsibility of the Ministry of Finance. The change process initiated in the State Treasury involved the restructuring of the Treasury, improvement of internal controls, as well as the improvement of information technology systems.

The new treasury structure was put in place as the result of a EU PHARE sponsored project on Technical Assistance to the Budgetary and Treasury Process between 1996 and 1999. It led to an organization organized along classic treasury lines with a clear separation of functions between:

- 1 Front office responsible for foreign and domestic financial resources as well as budget execution;
- 2 Middle office in charge of risk management and government accounting;
- 3 Back office responsible for operations.

The development of treasury operations has supported the Ministry of Finance to execute cash management and debt management at one place. It allowed control of cash outlays and put an end to the flow of funds through own bank accounts of the individual ministries. The integrated treasury is able to react more swiftly on budgetary developments and to foresee additional debt re-payments instead of only accumulating additional debt.

Major concerns existed concerning the information systems being used by the State Treasury.<sup>48</sup> They were considered to be ad hoc and in danger of not being able to cope with changes to the budgetary and treasury processes. Much effort has been made to resolve this. For instance, a general ledger system has been introduced. The development of the information technology has been considered as “*difficult*” projects. In spite of this, the system has been in place for 3 to 4 years and the deputy state treasurer believes that “*it works pretty well*”. The system presently enables management of debt flows and the next step forward will be to integrate it with the budget execution system.

The execution of the budget is still facilitated by two IT systems:

- An in-house budget execution system based in Oracle, which is a one year database, reporting system with no financial accounting function. This system stores details of the financial plans for each programme in the budget and reports on the status of the expenditures on a programme by programme basis over the course of the year;
- SAP, which includes a multi-year financial accounting module that currently is not linked to the budget execution system. The SAP system is not yet fully operational and is actually not viewed as being user friendly.

At present, all information recorded in Oracle is transferred to the SAP system. The latter system does have a budget execution module and will replace the existing in-house budget execution system in the long term. Currently, the State Treasury is preparing a new concept of budget execution, but definite decisions have not been made yet (July 2004).

A related problem has been the implementation of a budget planning IT system at the Budget department, which optimally should be linked to the treasury systems. Although, the system has been developed, the system is not yet fully operational. The major obstacle has been that system design has not fully taken into consideration users’ preferences. It is felt that the system is impeding the daily operations of the Budget department rather than assisting the department.<sup>49</sup> In 2004 a plan was made to make budget planning in SAP, but it “*did not work well*”.

Though the State Treasury considers that still many problems are to be solved before 2006 it believes it is already a step forward if the main issues are identified and broad ideas exist on how to go forward.

48 See Brian Olden, Strategic Direction of the State Treasury Function in the Czech Republic, January 2001.

49 See Final Report, Phare Public Expenditure Management Project, September 2003.

### 1.3.3 Internal audit

Latvia has developed a decentralized internal audit system, i.e. own internal audit systems are established within each ministry. The obligations and tasks of internal audit units and heads of institutions in the field of internal auditing and internal control systems are regulated since October 1999.

In 1999, an Internal Audit Department was established in the Ministry of Finance. As part of the *acquis*, but primarily due to Latvia's own willingness, it has put the appropriate legislation and regulations in place. The Ministry of Finance has the responsibility for the overall coordination of internal audit system and development of methodology. It has a right to perform peer reviews of the conformity of the activities of the internal audit units to the internal audit standards of the public administration. It is also responsible for elaborating standards for performance of internal audit units in the ministries. An Audit Council has been established whose role would be to receive and evaluate internal audits. This Internal Audit Council consists of five individuals and is seen as an important stage in the development of the internal control culture in Latvia. In 2001, the internal audit function at the Ministry of Finance was fully operational and in the years following, the Government also started to develop a modern internal audit system covering all line ministries and other large spending agencies. The new internal audit units have been staffed with well trained and experienced personnel. With support of the School of Public Administration a continuous training programme for internal auditors has been developed. The present system obliges line ministries and other spending agencies to submit their audit reports to the State Secretary of the ministry and to the Internal Audit department of the Ministry of Finance. The annual report is also sent to the Internal Audit Council and the State Audit Office.

Many people were initially against developing the internal audit function, but sometimes this was based on misunderstandings. For instance, at a too early phase attention was paid on performance audits, while systems audit and other basic audits were still in its infancy.

### 1.3.4 External audit

The State Audit Office has been changed independently from the Government's PFM agenda, though the requirements of the *acquis*, and own efforts have stimulated reforms in the area of external audit. The legislation has been put in place in line with the *acquis*. The new State Audit Office law strengthened the financial independence of the State Audit Office by abolishing the current practice of financing the office from fines and surcharges imposed on auditees.

The State Audit Office has developed a Strategic Development Plan 2000-2005, which is presently being implemented. To organize its work in accordance with international auditing standards and to obtain experience of the

work of supreme audit institutions in other countries, the State Audit Office has become a member of INTOSAI and EUROSAI. It has adopted the international auditing standards and formally carries out financial and performance audits. Some observers, though, still believe that the focus of the external audits has been on “*fact finding*” instead of systems audit.

The State Audit Office has developed its capacity in auditing of EU resources, also by auditing the implementation of PHARE projects in cooperation with the European Court of Auditors.

### 1.3.5 Macroeconomic and fiscal forecasting

Management of fiscal unpredictability has been supported by a conservative approach to revenue forecasting, debt and fiscal contingency management. Over the years, the Ministry of Finance has expanded its range of forecasting tools to be used for economic analysis, and to be valuable for the budgeting process. The models were designed and already formulated in the late 1990s. In the following years there existed a feeling that they should be updated, also because the Latvian economy had changed considerably since then.

Improvement was considered to be necessary. Besides macroeconomic and fiscal analysis and forecasting for the preparation of the State Budget, the Economic Analysis and Fiscal Forecasting department has (had) also the responsibility to prepare the economic scenarios for the former Pre-Accession Economic Programmes and the latest Convergence Programme.

Formal methodologies of the EU proposed to be used to prepare the Pre-Accession Economic Programmes and the Convergence Programme and the support of the PHARE Public Expenditure Management project provided advice on a number of these models as well as on new modelling issues, such as forecasting Latvia’s contribution to the EU.

### 1.3.6 Fundamental, functional, expenditure and programme reviews<sup>50</sup>

In 1999 with the assistance of World Bank, Latvia started developing and piloting horizontal functional reviews in order to streamline the administration, improve rationality, transparency, accountability in three sectors, i.e. agriculture, economy, justice.<sup>51</sup> The methodology of functional review was developed and piloted in three ministries, which allowed identifying the ministry’s mission, strategic objectives and functions to be retained, devolved, discontinued or undertaken in light of emerging priorities. As a result of the functional review, the Ministry of Agriculture restructured itself. The func-

<sup>50</sup> The State Chancellery also made efforts to improve ex ante policy impact analysis with the support of New Zealand consultants working under the umbrella of the UNDP. Progress has been made in impact assessments, which is considered by the State Chancellery to be a significant step forward.

<sup>51</sup> Before these reviews a more general horizontal review had been conducted in 1997, but without success.

tional review was the motivation to initiate strategic planning as well. As a follow-up in 2000 Public Expenditure Reviews were conducted in the Ministries of Agriculture and Justice as part of a World Bank Structural Adjustment Credit to further assist in bringing together organizational setting and budgeting issues.<sup>52</sup>

After this, with the support of the WB efforts were being made to initiate ambitious fundamental reviews but that initiative never got any ground. Within consultants' circles it was described as an *"everything of everything review"* being too ambitious not taking into account the existing capacity constraints in the public administration. It had a very wide scope and was not able to communicate the benefits to Latvia's short term horizon politicians. Soon after, more focussed programme reviews gained more ground, especially as it has been a compulsory activity for line ministries during budget preparation.

The large number of programme reviews had its base in ideas among some politicians to introduce zero base budgeting concepts to look for resources to fund the new initiatives of the then newly formed Cabinet.<sup>53</sup> The programme reviews were performed at two different levels:

- 1 At a decentralized level performed by the line ministry itself which would allow line ministries to keep the savings found to cover its priority task and to elaborate proposals for realization of new political initiatives within some programmes;
- 2 At a central level 19 programme reviews were conducted by an inter-institutional working group, which should result in finding extra resources to cover additional expenditure in order to maintain the fiscal deficit at a low level.

Like the US experience with zero base budgeting the experience in Latvia also proved that *"ZBB has led to volumes of paper work and even was seen as an occasion to ask for more money"*.

### 1.3.7 Programme budgeting and strategic planning

Programme budgeting was introduced at a too early stage in Latvia without having the necessary support infrastructure in place. It was felt that, though many documents circulating in Latvia discussed the problems, but in practice not much has been achieved. The State Treasury informed that the performance indicators are not always meaningful and it only implies that for the Treasury additional reports have to be prepared without having a real

52 See UNDP, *Rebuilding State Structures: Methods and Approaches*, Chapter 1: How to Build a More Effective Approach to Public Administration Reform, 2001. And Svetlana Proskurovska, *Structural and Organizational Reform: The Experience of Latvia*, in: *Mastering Decentralization And Public Administration Reforms In Central And Eastern Europe*, Gábor Péteri (Editor), 2002.

53 Cabinet Regulation No. 271, 30 April 2003, *on improvement and optimisation of formation and planning process of the state budget 2004*.

useful purpose. Other problems considered were the lack of clearly defined goals of budgetary programmes that basically led to emphasis on input indicators. There has been insufficient interest and knowledge about the application of the performance indicators during budget preparation as well as about the level of detail of the indicators depending on the size of a programme. The information collected was not really analyzed and therefore not used as the basis to prepare the budget.

This unsatisfactory situation stimulated in 2002 and 2003 the development of a new system of results and performance indicator guidelines, which was approved by the Cabinet of Ministers. The Guidelines comprises methodology on performance indicators as well as data collection issues. The guidelines were developed by the Ministry of Finance (Budget Methodology division) and the Policy Coordination division of the State Chancellery. Consultants who provided advice on best practice, contributed to drafts, gave training and various examples supported both institutions involved. These guidelines indicate some form of coherent approach towards improving the link between planning and budgeting.

Besides more clarity on the methodology, more emphasis is being placed on linking performance measurement to budgeting. Formally, the Minister of Finance has the authority to propose to the Cabinet to reduce the allocations for the respective programme if performance targets are not fulfilled. However, this authority has been seldomly used, since the ministries in question in most of the cases have been able to provide valid reasons for non-achievements. Strategic planning has been initiated to function as sort of medium term programme budgeting.

The aim of strategic planning has been to focus on the medium term strategic priorities and link these to annual plans, which in turn would have implications for programmes and sub-programmes of the programme budgeting system. Performance strategies of institutions are planned to be introduced in ministries incrementally by year 2006. The Ministry of Agriculture has developed the first strategic plan and it presented a model for the newly developed system of results and performance indicators. In fact the absence of in-year flexibility has promoted the participation of the Ministry of Agriculture in reformulating its programme structure. The Ministry of Economy and the Ministry of Finance also developed strategic plans in 2003. The Ministry of Health has recently joined the existing small group of line ministries.

The Parliament is not involved at all. Only the strategic plan of the Ministry of Agriculture succeeded to be set on the cabinet's agenda. Others only have support from the ministries concerned and the State Chancellery. The major problem considered is that strategies for individual ministries are being made while there is no overall Government strategy.

### 1.3.8 Medium term expenditure framework (MTEF)

Although for many years Latvia has made important steps in developing its conceptual thinking on MTEF development, not much has been done in this area, besides developing the macro and fiscal framework.

Foreign consultants and donors have made a sizeable amount of analysis on linking strategy development and the budgetary process in recent years.<sup>54</sup> The reports of these experts have provided a good basis for assessing where Latvia stands at the moment, what the main bottlenecks are in both processes, and where Latvia should go with MTEF development. The Government itself approved two important documents on MTEF development in 2001: “The “Policy Planning Guidelines” and the “Methodology Guidelines for Planning the Medium term Budget”. Most reports are very technical.

Latvian Ministry of Finance and State Chancellery officials are fully aware about the importance of a medium term perspective in budgeting, though doubt whether the unstable Latvian political system is conducive to support this. Experience in other countries has taught the necessity of engaging politicians in this type of fundamental budgetary reform.

### 1.3.9 The way forward

The State Chancellery has prepared a work programme for the next years, which is to be presented to the Cabinet. The draft document outlining a road map for reform has been elaborated with the support of the same consultants involved in strategic planning and a HM Treasury twinner. The document has not been circulated (yet) among a wider circle.

Though not very optimistic on its implementation, given the past experiences, staff of the State Chancellery still views budgetary reform as a “*personal challenge*.”

A working group is to be established led formally by the deputy State Secretary of the Ministry of Finance responsible for the budget. It would also comprise of officials of the State Chancellery, the State Treasury, the Ministry of Agriculture, the Ministry of Economy, the Ministry of Culture and the newly appointed director of the Budget department. It comprises the main proponents of the budgetary reform of the last two years. The main first task of the working group would be to define a commonly agreed reform programme.

54 Anne Evans, “Latvia’s Budget Planning and Priority-Setting process”, May 2001; John Mc William, “Medium term State Budget Planning – Final Report”, August 2001; Neil Daley, “Development of Methodology for Reviewing Public Expenditure Management”, September 2001; World Bank, “Republic of Latvia, Public Expenditure Review”, Report No. 22392-LV, February 2002; Geert Jennes, Various reports prepared in the framework of the Phare Public Expenditure Management Project, 2003.

## 2 Latvia: process of budgetary reform

### 2.1 Sequencing of reforms

In the 1990s Latvia made significant changes in the establishment of agencies, devolution of financial responsibilities to the line ministries and also in programme budgeting. However, most of the changes had been introduced at a very high speed, without significant support and overlooking the wider implications. At the end of the 1990s, Latvia understood more and more that public administration and budgetary reforms required a more careful, gradual approach involving all major institutions and requiring considerable support. Thereafter, Latvia followed the preferred mode of sequencing by firstly strengthening budget execution, internal controls and internal audit, particularly to address mistakes in the past with the too swift devolution of financial management to the line ministries and other spending agencies. Only in the latter years, serious attention was paid to the budget planning and preparation phase to address the too fast introduction of programme budgeting in 1996. Reforms in the budget planning and preparation phase are still in its early stage. However, the experience of the Ministry of Agriculture has illustrated an effective sequencing mode combining administrative reform in the Ministry with budgetary reform.

### 2.2 Management of reforms

The initiatives of the major actors in budgetary reform have resulted in remarkable achievements in budget execution, internal and external audit and to some extent in budget planning and preparation. Most initiatives were managed from the centre. Under the leadership of the (former) deputy state secretary of the Ministry of Finance (till June 2003) budgetary reforms have been largely coordinated and well managed, especially in the fields of treasury, internal control and internal audit, macroeconomic and fiscal forecasting.

In budget planning and preparation, an agreed coordinated approach existed mainly on paper. Even the system of results and performance indicator guidelines points to a logical approach towards improving the link between planning and budgeting consisting of the six subsequent phases.

- 1 defining policy priorities of the Government;
- 2 designing and evaluation of Government policies;
- 3 developing strategic plans of ministries and other institutions;

- 4 assessment of new policy initiatives;
- 5 analysis of budget proposals and budgetary programmes;
- 6 business planning and evaluation of government agencies;
- 7 annual statements of ministries, government agencies and other institutions.

In practice the different initiatives (i.e. strategic planning, medium term expenditure planning, performance measurement, organization reform and agency review) created the impression that these were separate and different things rather than slightly different facets of the same thing, i.e. a single coordinated reform process to introduce performance management into government. The diverse leadership in managing reforms in the budget planning and preparation phase, i.e. the State Chancellery and the Ministry of Finance, probably created this perception. This can also be attributed to the role of the various consultants and projects, which sometimes have put forward different views.

### 2.3 Different views on the role and capability of institutions involved in budgetary reforms

The diverse leadership of institutions engaged in the reforms in budget planning and preparation also led to different views on the role and the capability of each institution involved. One interviewed senior official mentioned that the Policy Coordination department was basically set up to coordinate all ministries' policies on behalf of the Cabinet and analyze new policy proposals of new Government. However, the official argued that that department was not really doing this. Major reasons mentioned were: (1) very young staff not really capable to "*compete*" with senior state secretaries and therefore taken less seriously; (2) too theoretical orientation which is of less interest for practical seniors officials within the Government; (3) disproportionate amount of time spend on details with regard to strategies of individual ministries and various methodologies. Some other officials consider that the Ministry of Finance still think and work as an accounting office and do not yet think more strategically. Non-Ministry of Finance officials wanted to "put more pressure" on the Ministry of Finance to become more pro-actively involved and not being over occupied with day-to-day work.

### 2.4 Ownership

Due to the leadership of the (former) deputy state secretary, Latvia owned the budgetary reforms, though the degree of ownership varied among the institutions involved. This has been considered existing within the State Treasury, the Internal Audit department, and the Economic Analysis and Fiscal Forecasting department, but to less extent in the Budget department. The State Chancellery has ambitious staff that continuously attempts to involve politics into the reform process. Although the dedication of the staff is high, success of their initiatives depends heavily on the commitment of politicians.

Nonetheless, in the last few years the State Chancellery have been able to acquire more responsibilities, such as agency reform, which would allow them to improve coordination and putting the issues on the agenda of the prime minister.

It is acknowledged that there has been insufficient ownership of the budgetary reform process and outcome by line ministries and their political heads. Notable exceptions have been the Ministry of Agriculture, the Ministry of Economy and the Ministry of Culture. Most line ministries place an over reliance on the Ministry of Finance during budget preparation to pull ‘rabbits out of the hat’ in terms of finding extra funding. In this respect, all the fundamental and programme reviews conducted so far have been half hearted and less effective and have just tended to generate additional budget requests.

## **2.5 Lack of national strategies**

Even though Latvia has prepared the Pre-Accession Economic Programmes and the Convergence programme, the stated medium term policy strategies did not actually represent a policy and long term vision. Political volatility induced the short horizon of ruling politicians. Strategies developed were not linked to multi-year budgetary constraints. Each year, during budget preparation ministers would argue for more resources. For instance, in the education sphere, the focus was just on higher teachers’ salaries and not on how the educational system could be improved to achieve more value for money. Ministers did not propose institutional changes or changes in laws and regulations, for instance concerning social benefits. The Ministry of Agriculture is regarded as an exception, since senior political and ministerial management moved forward with first restructuring and then development of its strategic plan. Its plan is till now the only one that received cabinet approval. Concerning most other line ministries, the short term budgetary horizon encouraged merely higher requests for money, whilst not looking to how to manage the resources better. When expenditure reductions had to be made the focus has been on delaying payments or deferring IT, investments, maintenance and software updates.

## **2.6 Management of budgetary reform coincided with management of technical assistance.**

In Latvia technical assistance funded by donors has been considered the same as own government money. In the words of various officials: *“It has to be spent well”*. Most of the officials interviewed consider that they got the technical assistance they wanted. Technical assistance was sought for when budgetary reforms were foreseen. While some forms of technical assistance were targeted to one institution or department only, there have been larger projects, which focussed on more than one department. For instance, a large PHARE Public Expenditure Management project in 2002 and 2003 involved

the Budget department, the Economy Analysis and Fiscal Forecasting department, the Internal Audit department as well as the State Treasury. The five Components of the project were:

- 1 Strengthening the fiscal forecasting function;
- 2 Follow-up to the implementation of the Budget Planning IT system;
- 3 Multi-annual budget planning;
- 4 Sound financial management;
- 5 Development of the internal audit function.

## 2.7 Pilot ministries to test new concepts

Particularly in the field of priority setting and budget planning and preparation, many initiatives, such as the functional reviews, public expenditure reviews and strategic planning never got further than the stage of pilots. State Chancellery staff acknowledged that involvement of more ministries from the start, instead of only the Ministry of Agriculture, would have been better. It also argued moving faster so that wider acceptance and more results could have been achieved. Though it is understood that the lack of political commitment would have to be addressed as well. Pilot ministries deem that strategic planning have increased their workload, particularly since they have to submit information according to the “old” rules as well as according to the new formats required through the strategic planning.

## 2.8 Existing limitations in budgeting stimulated pilot ministries to participate

As mentioned, in-year budget flexibility is rather limited in Latvia, except through supplementary budgets. Extensive controls still exist for economic items. The strategic planning pilot in the Ministry of Agriculture allowed them to reduce the number of programmes from 34 to 9, which increased the possibility to shift between items during budget preparation, and reduced the necessity to ask for approval for in-year shifts. Senior management of the Ministry of Agriculture confirmed that this was a major reason to be the first pilot in strategic planning.

The major reason for the existing strict rules is, as indicated by the State Treasury, the “*lack of trust*”. Even so, it is recognized that further development of finance and budget departments within line ministries would be required to allow them to function as a “little Ministry of Finance” within a line ministry. The treasury remarked that EU experience in that field would be welcome.

## 2.9 Building internal training capacity

The Latvian School of Public Administration was established in late 1993 to assist in the implementation of civil service reform efforts. The school offers in-house training programmes for civil servants and administers civil service

examinations. The School has been active in providing basic courses in the area of internal audit. Accredited lecturers, mainly comprising staff of ministries, provide courses. Since the Autumn of 2004 the School falls under the responsibility of the State Chancellery. However, many consider that the courses provided are on a basic level and modern budgeting courses are not provided. The State Chancellery showed keen interest in experiences of Public Finance Schools in other EU member countries.

The Ministry of Agriculture and the Ministry of Economy has provided support to other (pilot) ministries in strategic planning. Staff has provided courses at the School of Public Administration together with the State Chancellery. A common view is that “*these line ministries lead in this process*”.




# 3 Latvia: role of capacity building in budgetary reform

## 3.1 Priorities in capacity building

Though one can speak of a certain sequencing of budgetary reforms, the building up of capacity in Latvia showed also to a certain extent a clear sequence, namely:

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Organizational change – Change in PFM techniques and tools – Changes in information technology 

This can be said about the changes made in the State Treasury, the Internal Audit department as well to some extent to changes in the State Chancellery. But it has not (yet) been the case for the Budget department.

Besides these aspects, the interviews showed clearly other key elements so far in building up PFM capacity in Latvia, namely the changes related to management style, organizational culture and individual attitudes. The latter elements were not specifically perceived as part of capacity building in Latvia. Besides, training, participation in study tours, on-the-job assistance and advice officials were not openly exposed to the requirements towards organizational behaviour conducive for effective public finance management. Important questions were not sufficiently addressed and even not considered. Also technical assistance did not really touch issues such as:

- 1 Consideration of other ways of management, besides management by hierarchy;
- 2 Adequate sense of balance between risk taking and risk avoiding behaviour;
- 3 Stimulation of pro-active and anticipating behaviour;
- 4 Whether staff and management are stimulated in their daily work;
- 5 If the organization and its staff are willing to learn from its past mistakes.

In that respect the (former) deputy state secretary of the Ministry of Finance questioned whether people really understand the key issues when they talk about implementation of budgetary reforms. Institution building and strengthening in PFM means more than the introduction of new or adapted laws and regulations. It also implies change management elements and skills building and these aspects are often underestimated.

### 3.2 Capacity building in the State Treasury

As mentioned, capacity building at the organizational level implied the establishment of a new structure. This structure was put in place with the support of a EU PHARE sponsored project on “Technical Assistance to the Budgetary and Treasury Process” between 1996 and 1999. It led to a Treasury in Latvia that is organized along classic treasury lines.

Capacity building has been supported by substantial technical assistance. This was in the area of debt management, payment systems and budget execution. Most is considered to be successful, but in a few cases there was no readiness yet to really make changes within the treasury and the Budget department. Assistance has also been provided by the various donors (incl. the PHARE programme) in the field of the introduction of various information technology solutions to meet the business needs of the State Treasury. The State Treasury considers that the following factors played a role in using technical assistance effectively:

- 1 well prepared receiving institutions;
- 2 highly qualified experts;
- 3 twinning projects (“*practical and useful*”);<sup>55</sup>
- 4 combination of theory to foster new ideas and to change people’s mind and views as well as practical support in implementation issues.

The State Treasury has links with the Estonian Treasury, which allows benchmarking in the Baltic region.

### 3.3 Capacity building in internal and external audit

The road of understanding the modern role of internal audit and the creation of an environment for it to establish and develop was part of a PHARE funded project “Public Administration Reform in Latvia“. Much effort was made available in the initial stages of the project to establish the legal basis of internal audit and install credible internal audit units in a number of pilot areas.

That PHARE project was able, through a combination of hands-on activity linked to training and development, to establish a cadre of auditors in all the main ministries and spending agencies. The development included audits within the ministries dealing with both budgetary and EU funds and provided a pathway for the future through a specific manual including audit programmes. Training that was undertaken was focussed and practical, allowing for the development of not only auditing knowledge but also for the necessary development of the managers. Part of the capacity building was creating of internal training capacity through certification allowing certified

<sup>55</sup> Presently a twinner is working on EU funds.

lecturers to deliver basic courses on internal audit in the School of Public Administration.

A large component of the PHARE Public Expenditure Management project was dedicated to build further upon the achievements made so far.

With regard to external audit, the State Audit Office has developed a strategic plan for 2000-2005. Since approval of the new State Audit Office Law new posts have been created. For many years training has been provided to its staff members. Courses were offered by the School of Public Administration, international institutions and officials from supreme audit institutions of other countries. Pilot audits have been carried out in close cooperation with the European Court of Auditors and were completed in January 2002.

The State Audit Office has implemented a twinning project “Improving Public Expenditure Management” with the UK National Audit Office. The State Audit Office aims to further increase its administrative capacity in the framework of a twinning arrangement with the Netherlands Court of Audit.

To organize its work in accordance with international auditing standards and to obtain experience of the work of supreme audit institutions in other Western countries, the State Audit Office has become a member of INTOSAI and EUROSAL.

### **3.4 Capacity building in macroeconomic and fiscal forecasting**

The Economic Analysis and Fiscal Policy Department of the Ministry of Finance exists since 1996. The department consists of three divisions: on macroeconomics, fiscal analysis and public sector data. Both the Macroeconomics division and the Fiscal Analysis division prepare forecasts. The department works together with the Ministry of Economy whose macroeconomic modelling results are imputed in the fiscal forecasting models of the department. The Ministry of Economy also prepares long term forecasts for 30 years ahead. Organizational changes did not really materialize since the department’s establishment, though there has been a discussion to establish a special research institute (like the Netherlands Bureau for Economic Policy Analysis), but the discussion was halted due to financial and legal obstacles ahead.

Capacity building interventions were focussed on training abroad, development of new models by foreign experts in close cooperation with the departmental staff and twinning. Staff has followed IMF courses in Vienna specially focussed on the Baltic States (end 1999-2000), OECD courses on tax revenue forecasting and recently courses in Brussels to understand EU methodologies. A twinning project with the German Ministry of Finance included the development of a new expenditure model. Staff considers that the models

are used in practice for policy purposes and indicated that “*about 80% of the results of technical assistance are used*”. Besides advice on updating models, such as LATIM-F, as part of the PHARE Public Expenditure Management project, a study tour to the Netherlands was organized in June 2003, during which the Netherlands Bureau for Economic Policy Analysis (CPB) was visited to discuss the role of macroeconomic models in the Netherlands policy debate, and to the Ministry of Finance to discuss how the Netherlands deals with the contributions to the EU (including forecasting of these contributions, negotiations with the EU and the impact on the budget).

International links exist primarily with the other Baltic States, for instance on projecting own resources contribution to the EU.

The department has been confronted with very high turnover of staff. Many young graduates considered this department as a good starting point for their career and stayed on average for only 2-3 years. Therefore the department has a good base for short periods and then developments would stop over and over again.

### **3.5 Capacity building in modern budget preparation**

Capacity building in modern budget planning and preparation has been targeted to the Policy Coordination department of the State Chancellery and the Budget department of the Ministry of Finance.

The State Chancellery acts as a central administrative institution and ensures necessary professional support for work of the Cabinet of Ministers and the Prime Minister. A major task is to ensure the quality of the legal and regulatory acts submitted for adoption by the Cabinet. Till the beginning of 2000, it was considered that the policy advice function at the State Chancellery was underdeveloped. Therefore, the Latvian government established a central strategic planning and policy coordination capacity, namely the Policy Coordination department. This department has three main functions:

- 1 Preparation of medium- to long term Government plan concerning the future policy and legislative agenda;
- 2 Coordination of ministries in their preparation of draft policies in accordance with the medium term policy framework and to ensuring the coherence of the new policies with the already adopted ones;
- 3 Undertaking the development of policies on the emerging issues, which do not fall under the responsibility of any ministry.

Moreover, the Policy Coordination department is also heavily involved in the agency reform and till May 2004 it was extremely busy with aligning national legislation to the EU regulations.

The State Chancellery received support from DFID, the British Council (through its ISPELL project), the World Bank, the UNDP, and the University

of Illinois. They consider to have received “*value for money*”. The reform agenda of the State Chancellery allowed them to use the consultants to their full potential.

The Budget department as well received significant assistance, but unlike the State Treasury that department paid too much attention to day-to-day issue and staff was constantly occupied in extinguishing political fires, instead of taking time to “think strategically”. Operational day-to-day issues “*dictated the agenda*”. The new deputy director of the Budget department understands this persistent problem and aims in the near future to change the department into a “*learning organization*” understanding that the impetus for budgetary reform should come from within the organization. Other senior officials argue that it is specifically this department that suffers the most from the frequent changes of Ministers of Finance. Its activities are highly dependent on the strength of the Minister.

Similar to the Economic Analysis and Fiscal Policy department, staff turnover is high, especially among relatively new staff. It has been argued that staff, which stayed already for a long time in the department, must be approached differently to involve them in budgetary reform. This aspect of differences in background and attitudes among staff of the same department are mostly overlooked, leading to disappointments from both sides, i.e. recipient and technical experts.

Technical assistance did not really acknowledge the difficult “environment” in which the Budget Department had to operate. A possible resolution noted by the new deputy director would have been that the Budget Department should have been more pro-actively involved in preparation of technical assistance at the earliest stage as possible, allowing to consider the tension between daily work and new approaches and allowing better interaction between experts and Budget department staff. In some cases good opportunities have been missed, since the Budget department was not adequately involved and therefore ownership was absent. Also some new methods and tools, such as Medium term expenditure framework, were too premature to be introduced in Latvia and therefore experts did not receive ample response from Budget department staff.

Moreover, large projects were divided in too many components, while only some of them addressed the activities of the Budget department. Therefore, staff could not see the wider picture were things would fit in. Finally, projects were in some cases too tight implemented according to rather inflexible Terms of References, not allowing revisions, which are essential in the dynamic Latvian political environment.<sup>56</sup>

56 A fresh example is that Latvian data are not yet fully in line with ESA 1995 standards. Data submitted in the March 2004 fiscal notification were not validated by Eurostat. The EC assessment mentions that serious questions persist over the quality and consistency of the underlying data. Urgent work to align fiscal data to ESA 1995 requirements therefore dominated the work of the Methodology division. It was hoped to find somewhere technical assistance able to be mobilized at short notice.

Just recently, significant changes were made among staff in the Budget department. Many left the department and new recruitments were made. Also the director and deputy director are new. In the Methodology division only one staff member remained and the rest are new, including the head of that division. The new management understands the realities for the Budget Department and looks for ways to “empower” its old and new staff members to enable them to face the new budgetary challenges. This will be a very difficult task. By keeping to its “old” habits” the Department is still overwhelmed by paper work, not having time for long term reforms. It has been argued that work is less interesting for young people to get them motivated and to keep them long. New staff will need at least 2 years of experience or as an absolute minimum one-budget cycle to be effectively involved in the work of the Budget department.

Unlike the Ministry of Finance, staff turnover in the Ministry of Agriculture is not so high, though in a number of departments it still poses a problem. There are now more economists and legal specialists in the Ministry employed. Senior management have the possibility to receive additional bonuses, though the lower levels lack this possibility. Capacity building is regarded as important to keep staff motivated and allow them to upgrade their skills through training, but it is not considered as a replacement for drastic salary reform. The relative stability in key senior staff has enabled the reforms. Also the State secretary<sup>57</sup> is at her position for more than 4 years as well as the head of the financial department who also already works for many years. Both are considered to be the main drivers of reform in the Ministry of Agriculture having an exemplary role in budgetary reform for other line ministries. The Ministry has been pro-active in implementing reforms, and has actively participated in the functional and subsequent public expenditure review leading to a restructuring of the Ministry. It has been the first pilot in strategic planning and recently it volunteered for a comprehensive systems audit with the State Audit Office of Latvia. In key stages of the reforms the main driver was senior management of the Ministry itself.

The restructuring of the Ministry of Agriculture led to a division between the central Ministry and executive agencies responsible for payments to farmers. Some changes were influenced by the EC, though the internal drive to have a similar structure as in other EU member states played a more significant role. Ministers have been more stable. The last two cabinets had the same minister and before that different ministers, though from the same political party. Moreover, most political leaders had an agricultural background knowing the peculiarities of the sector and the possible consequences for the farmers.

57 Some deputy state secretaries even longer.

### 3.6 Capacity building at the individual level

An important prerequisite for the implementation of new budgetary procedures and methods is that it builds on the knowledge and skills of the officials involved. This task has two sides: (1) technical: transfer and adaptation of new methods; (2) building up human capacity which will be able to absorb new practices. Besides study tours, technical assistance foresaw in training workshops, seminars and on-the-job advice to transfer the necessary skills and knowledge to the Latvian officials.

Whilst changes in managerial skills and in organizational culture did not receive much attention, there were exceptions to this rule. For instance, in the State Treasury turnover of staff in the State Treasury has been relatively low. The deputy State Treasurer considered that this has been due to:

- open minded senior management able to make changes. In the words of the deputy State Treasurer: *“The culture in the Treasury is open which allow supporting new ideas.”* *“Unlike other institutions, historical rules were broken.”*
- senior management capable of knowing ways to motivate staff.
- possibility to follow training and even study abroad when senior management sees potential.
- young staff being coached by senior staff in the treasury.

Technical assistance did not pay attention to the lack of real management experience or management training of senior officials. But the major problem is still the much more attractive labour conditions in the private sector. For instance, within the Ministry of Finance, there are no special incentives for staff. There exists a bonus system, but distribution is not so much based on merits, but on equitable distribution among staff. Senior staff considers as existing motivating instruments (1) a good working environment, (2) salary and bonus (!), (3) the possibilities to follow some courses, (4) in some cases paid study abroad. Young graduates though find the Ministry of Finance an attractive working place and work at the Ministry for a few years to acquire new knowledge and prepare for further graduation. Last year it was possible to attract students from all levels, but since this year departments are only allowed to attract students who have a degree already (minimal B.A.).

Finally, a major weakness of technical assistance has been the non-involvement of politicians. Though, the role of politicians is perceived by Latvian ministerial staff as very crucial to continue with budgetary reforms, technical assistance never considered special workshops for high level politicians as possible vehicles to get them involved and supportive.



## 4 Latvia: conclusions and lessons learned

This case study focussed on the most important budgetary reform initiatives in Latvia. Besides describing the political, economic and fiscal environment it addressed the sequencing of budgetary reforms, the responsible actors involved, the content of the reforms and the process of implementing budgetary reforms. Various ways of interventions were discussed by focussing on wider organizational impact and effects and interventions on the individual level. In some cases both are intertwined and could not be separated from each other.

Budgetary reforms in the last few years in Latvia seem to have followed the general advice on sequencing. The main focus has been on improving budget execution by the strengthening of the treasury, establishing internal controls and strongly emphasizing the importance of internal audit throughout the public sector. Improvements in these areas are continuous and one cannot say at what time reforms have been finalized or halted. Nevertheless, it is fair to conclude that Latvian has followed the basic route. It has progressed now towards the area of budget planning and budget preparation. In the latter case, it is hard to say when reforms really started, since for instance when the country embarked on a swift introduction of programme budgeting in the 1990s without really overseeing the implications of introducing such radical reforms. This resulted in that the programme structure of the budget was in name only. In 2002 it was believed that improvements had to be made. A stronger link had to be established between policies and budgets and also the “management of programmes” had to be strengthened. Improvement of programme budgeting was addressed by strengthening the performance measurement guidelines and strengthening the link with policies by strategic planning, i.e. in Latvia a form of multi-annual programme budgeting, though without clear multi-year ceilings set beforehand.

In some cases changes have been initiated, but did not have any follow-up, mainly due to the lack of political backing. Latvia’s political process has a tremendous focus on today and tomorrow – especially on drafting and proclaiming new legislation – paying insufficient attention to monitoring of progress in implementing earlier initiatives.

It is fair to conclude that while external anchors have been important in giving politicians a clear road towards improvements, such as the IMF

stabilization programme and the *acquis* requirements, major changes were initiated from the internal apparatus of ministries, and notably the Ministry of Finance (including the State Treasury), the State Chancellery and a line ministry as the Ministry of Agriculture. Latvia started with developing a modern treasury and internal audit much earlier than *acquis* negotiations started. Special programmes of the World Bank have been an engine for, for instance, pension reform, but it had not a general impact on budgetary reforms in the whole public sector.

An important initiative, which did not survive the unstable political environment affecting budgetary reforms, has been the introduction of fundamental reviews. A major struggle has also been agency reform, another area that Latvia embarked upon too quickly in the 1990s without overlooking the implications of making organizational changes in the public sector. That struggle is still going on and it seems that the persistence from the side of the agency reformers will finally bring the long awaited results.

Despite the fragmentation of the institutions responsible for budgetary reform, a major factor has been strong leadership and vision of senior officials at the Ministry of Finance, who were strongly supported by forward looking senior managers within the Ministry of Finance and in other organizations. In some departments and organizations senior managers supported the reform efforts, though day-to-day operational issues in budgeting crossed their involvements. They were responding and reacting more than anticipating and initiating.

Main lessons, which can be drawn for the Latvian experience, are:

- 1 Stable political environments are more needed for making changes in budget planning and preparation than for reforming budget execution and internal audit.
- 2 It is important to have first a budgetary reform strategy to guide capacity building. This will allow also managing the activities of various donors better, which will increase the effective use of the resources.
- 3 For developing a coherent approach towards budgetary reform and capacity building it is necessary to have a commonly agreed agenda by involving all main reform drivers instead of having separate plans. Foremost, there should be enough reform managers to keep the pace of reform. Some officials have argued that since the departure of the former deputy state secretary of the Ministry of Finance the reform process has practically stopped.
- 4 It is vital for maintaining the momentum to involve a critical mass of line ministries. Particularly line ministries and other spending agencies, which resist, should be supported to see new budgetary processes as useful and as an opportunity rather than as a centrally imposed burden or a way to introduce budgetary cuts.

- 5 In a political unstable environment it is very difficult to engage in drastic budgetary reforms, because of the absence of long term visions and political commitments. If there is political commitment, capacity will be built faster; without it will be less effective.
- 6 Besides introducing new tools and methods, parallel institutional reforms must be undertaken. Also hindrances coming from over-occupation for day-to-day work, which can stifle new initiatives, should be tackled. Budgetary reform is thus wider than technical instruments, but also encompasses organizational changes, such as organizational culture, managerial skills and attitudes. In the words of a senior reformer: budget reform requires *“quite significant changing people’s attitude.”*
- 7 Improved communication structures, both formal and informal, between all institutions involved should receive more attention. Most technical assistance and other capacity building interventions are focussed on one institution only.
- 8 Finally, besides addressing capacity building, the roots of problems should also be tackled, i.e. retention of qualified staff.



## 5 Interviews Conducted in Latvia

Parex Banka	
Mrs. Inguna Sudraba	Vice-president Parex Banka, Former Deputy State Secretary, Ministry of Finance till July 2003.
Ministry of Finance	
Mrs. Daiga Gulbe	Director Economic Analysis and Fiscal Policy department
Mrs. Ilona Stepanova	Deputy director Economic Analysis and Fiscal Policy department, Head of Fiscal Analysis and Forecasting division
Mr. Vladimirs Cernavskis	Deputy director Budget department, Head of the Budget Methodology Division Senior official of the Budget department
State Treasury	
Mrs. Gunta Medne	Deputy State Treasurer
State Chancellery	
Mrs. Una Klapkalne	Deputy director of the State Chancellery, Head of the Policy Co-ordination Department
Mr. Ugis Sics	Deputy head of the Policy Co-ordination Department
Mr. Janis Jankovskis	Deputy head of the Policy Co-ordination Department
Ministry of Agriculture	
Mrs. Laimdota Straujuma	State Secretary
Mr. Janis Snore	Director Department of Budget and Finances
Ministry of Economy	
Mr. Andris Liepins	Deputy State Secretary



## **Annex C:**

# **The Case of Bulgaria**



# 1 Bulgaria: background of budgetary reform

Bulgaria is a relatively small country. It has a shrinking population but is blessed with a political and social stability that was not common to many other Balkan countries in the 1990s. It is now firmly on the path towards accession to the European Union after the country made a remarkable turnaround in 1996/1997.

Along with Latvia, Lithuania, Romania and the Slovak Republic, Bulgaria was invited in December 1999 in Helsinki to start negotiations towards EU membership. Its economy was largely stabilized then despite a difficult external environment, growth had resumed and been sustained over two consecutive years. The legacy of heavy indebtedness, however, will continue to be an important factor as the country faces the dual challenge of transition and EU accession.

**Table 3 Basic economic data on Bulgaria**

Basic data	1996	1997	1998	1999	2000	2001	2002	2003
Population (1,000; average)			8,257	8,211	8,149.5	7,891.1	7,845.8	7,801.3
GDP (current, billion EURO))			11.4	12.2	13.7	15.2	16.6	17.6
Real GDP growth (% change)	-10.1	-7.0	3.5	2.4	5.4	4.1	4.8	4.3
GDP (current p.c.)			1,400	1,500	1,700	1,900	2,100	2 300
GPD (current, p.c., PPP)			4,600	6,000	5,800	5,800	5,900	
Exports as % of GDP	62.9	61.9	48.6	44.1	38.4	37.6	36.7	37.9
Imports as % GDP	59.8	56.4	52.1	51.9	47.9	49.3	46.9	50.4
CPI (Change p.a.)	123.0	1082.2	22.3	2.6	10.3	7.4	5.8	2.3
EUR/LEV exchange rate			1.955	1.955	1.955	1.955	1.955	1.955
Unemployment rate (p.a.)	11.0	14.0	12.2	13.8	18.2	18.1	17.7	14.3
General Government balance - /+ (% GDP)	-10.3	-0.4	1.3	0.2	-0.6	-0.6	-0.6	0.0

(Source: Ministry of Finance)

Until 1997, Bulgaria was one of the poorest performing economies of central and eastern Europe (CEE). Massive external borrowing, stop-and-go stabili-

zation policies and a slow pace of structural reforms marked the preceding decade. As a result of the failure to establish market discipline, widespread rent-seeking, and soft budget constraints among enterprises, banks and the government budget alike, Bulgaria's problems culminated in a severe economic crisis in 1996/1997, in which GDP saw a cumulative decline of nearly 14%.

After a few months of chaos involving a period of hyperinflation, the collapse of the banking sector and a major foreign exchange crisis, Bulgaria adopted in 1997 a Currency Board Arrangement (CBA). The CBA was considered the best cure to the soft budget constraints and commercial bank financing that kept loss making enterprises afloat, and to the lack of fiscal discipline that led to hyperinflation.

The CBA has been underpinned by a conservative fiscal policy and a significant acceleration of structural reforms. The wide ranging structural programme consisted of reforms of the social sectors, agriculture, energy, privatization, restructuring and bringing financial discipline in the private and banking sectors, and liberalization of prices and trade. Sound macroeconomic management and the acceleration of structural reforms succeeded in restoring growth, reduced inflation and reassured the public and investors.

Following the introduction of the CBA, interest rates dropped sharply, inflation declined dramatically, and the fiscal deficit was reduced to more sustainable levels. Real output recovered and grew by an average of 4% a year after 1998. This improved performance took place in a difficult external environment of turmoil in international markets, unfavourable development of commodity prices, Kosovo crisis and at the beginning of the century a global economic slowdown.

With the date of accession set for 2007 and approaching rapidly, the importance of the EU and the accession process is growing and defining almost all areas of Bulgarian policy making. According to the latest report (2003) by the EU on Bulgaria's progress towards accession Bulgaria is progressing steadily, but major points of attention still include flexibility of product and labour markets through proper legislation, privatization, preparation for Structural and Cohesion Funds and anti-corruption measures.

## **1.1 Reforms in public finance management**

When the process of budget reforms actually started in Bulgaria is to some extent a matter of perspective. Most people would point at the adoption of the currency board arrangement as the proper start of budget reform, but several significant changes also took place before that date. To some the installation of Parliament is one of the first major reforms that also started budget reform. Although this may be very true and its importance cannot be

underestimated it is such an important and general reform that it is difficult to attribute this to budget reform specifically. A more clear-cut example is perhaps the re-establishment (by Parliament) of the National Audit Office in 1995. With a small office and a governing body of 11 persons elected by Parliament the Audit Office started activities, but nowadays it is a professional organization with over 600 staff of which more than 180 are located in one of the 6 regional offices. Other important institutional steps that were already started before or during the crisis of 1996 were the confirmation of the independence of main institutes of the State including the Central Bank and the adoption of a new comprehensive legal framework under the Organic Budget Law in 1996.

To most people, however, budgetary reforms really took off with the adoption of the Currency Board Arrangements in 1997. It was only then that the Government of Bulgaria committed itself to strict fiscal discipline and consequently started a process of reform measures in the field of public finance management.

With fiscal policy set by the strict rules of the CBA the Ministry of Finance set out to strengthen its overall structures and organization and staff in the Budget and State Treasury Departments to enhance control over spending. One of the major tasks was to make the budget comprehensive. By reducing the amount and number of off-budget funds (more than 50 at that time), consolidation of own revenues of spending agencies into the budget and the reduction of the number of spending agencies (about 150 at that time) order was brought to a previously difficult to manage budget structure. A most important reform in this respect was the set-up of a Single Treasury Account at the Central Bank that was gradually extended to include all spending units and funds.

Other reforms focused on administrative systems through changes in the Unified Budget classification and a revised chart of accounts, which is broadly consistent both with the IMF revised GFS system as well as with EU standards. In addition the legal and administrative framework for financial control was strengthened by clearly defining the responsibility of the Public Internal Financial Control Agency (2000) and by a new law providing regulations governing procurement that was adopted in 1999.

In this period in which so much attention was paid to installing and maintaining fiscal discipline, several other steps were taken that would direct the reforms towards the end of the century and the beginning of the new one. During this period the preparations for Financial Management and Information System (FMIS) were started and the Ministry of Finance undertook with the help of the IMF and consultants several assessment studies into the PFM system to determine a future path of reform. This resulted in 1999 in a strategy document called “Development of a Medium Term Strategy and Structures for the Ministry of Finance”, that laid the foundations for several

ensuing reforms. Important elements were the growing importance of the European Union as the perspective of EU accession started to become real, a greater emphasis on the new role of the Ministry of Finance and how it should change in order to lead the necessary reforms in public finance management to improve resource allocation and operational efficiency.

The restructuring of the Ministry of Finance, which actually started in 2001, tried to accommodate a new role for the Ministry of Finance and facilitate a longer term approach towards budgeting. A host of measures were introduced that culminated in the approval of a new Structural Regulation governing the role and functions of departments within the MoF. The budget execution and accounting functions of the former Budget and Treasury Directorate were separated and a Budget Directorate was established with a strategically oriented focus. A new State Expenditure Directorate was the result of the merger between three previously separate expenditure directorates. Among the changes was also the establishment of new Directorates for European Integration and Human Resources. The role of human resources was made more prominent in the organization and the internal structures and responsibilities were more explicitly defined in functional descriptions for divisions as well as job descriptions at staff levels. Within the Ministry of Finance a Public Finance School was set-up that was inaugurated in Spring 2004, and has the specific responsibility to build capacity inside the Government system on budgetary issues.

To facilitate a more structural and medium term perspective into budgeting the roles of budgeting and expenditure controls were split into three departments (Budgeting, Treasury, State expenditures) each headed by a Deputy Minister. Preparations started for a Medium Term Expenditure Framework (MTEF) and the economic modeling capacity was improved in the Agency for Economic Analysis and Forecasting, which is a semi-autonomous agency under the Deputy Minister of Finance responsible for budget planning and preparation. At a practical level the budget cycle was brought more forward into the calendar year to allow for more time to prepare the budget. Starting with the budget for 2003 a 'budget policy paper' was introduced defining inter-sectoral priorities and estimating the fiscal impact of policy changes. An effort was also made to involve the line ministries more in budget preparation through improved guidelines, setting detailed expenditure ceilings and requesting multi-year expenditure estimates and prioritization of programmes.

Another important step was the development and introduction of a Programme Budgeting (PB) approach. Starting in 2001 with the Ministry of Environment the MoF developed clear guidelines and procedures for a new budget classification based on policy objectives and programmes. In 2004 about seven ministries have joined as pilot projects, which is still additional to existing economic and functional budget classifications. The roll-out of the

programme budgeting shall be completed in 2006. In 2004 the budget cycle for PB was closed for the first time for the Ministry of Environment as it reported on expenditures according to the programme classification for the first time.

Another field in which major reforms took off in the past few years is the area of intergovernmental relations in particular with regard to municipal finances. In 2002 the Council of Ministers approved a programme for implementation of fiscal decentralization. Important topics of this reform include a clear framework of intergovernmental responsibilities, standards for service delivery, matching revenue collection with expenditure needs, maintaining fiscal discipline and a greater participation of citizens in the planning and execution of municipal budgets. As of today the reforms in municipal finance are under implementation after the legislative frameworks were developed and approved and standards for service delivery and costing were established. To counteract differences in revenue generation between municipalities equalization funds are provided.

Different other areas of public finance underwent substantial changes in the past decade notably in the tax administration and the customs office, but these are not being elaborated upon in the context of this study.

## **1.2 Results and the agenda ahead**

It is not so easy to clearly distinguish between reforms in Bulgaria that were successful and those that were not. Some had to be tried several times before results showed and others went smoothly and instantly. It is almost for sure that the persons interviewed also forgot about reforms that may have been started but did not succeed and were dropped consequently. A more general apprehension of the budgetary reforms would state that Bulgaria has established appropriate institutional and implementation arrangements to ensure aggregate fiscal discipline. Effective controls over cash flows have been ensured and since 1997 public expenditures have been held under tight financial control. Perhaps as an indicator of that success Bulgaria became the first EU accession country candidate accredited to manage the Special Accession Programme for Agriculture and Rural Development (SAPARD) funds under the same guidelines as EU member states.

Despite these successes in gaining control over government finances Bulgaria has embarked on a very different set of reforms since the beginning of this century which are too fresh to be evaluated at present. Nevertheless a broad summary of the future agenda for budgetary reform also gives an insight into those areas or topics where reforms have been relatively slow to pick up or are just beginning.

The main challenges for public finance in Bulgaria relate to improving allocative efficiency and operational efficiency. In a way this all starts with an increasing predictability within the overall budget for spending units for a longer term period being able to make their own budget decisions. Bulgaria has managed to look further ahead, but is still struggling to make effective projections for the medium term. These difficulties may point to several influencing factors but include the large responsibility and authority for the budget of the MoF vis-à-vis the spending units that is mirrored in the weak capacity of these spending units for linking policy making and budgetary planning in their own policy areas. Similarly, the Currency Board Arrangement has brought Bulgaria tremendous benefits in terms of stability and gaining credibility and understandably Bulgarian policy makers and the public are weary about giving up such a successful institutional set-up. However, the CBA is in a sense a technocratic arrangement that substitutes to some extent a more political agreement about fiscal policies. This also reflects upon the development of the MTEF, to a large extent a political agreement by nature, which the Ministry of Finance is trying to develop. It has become clear that in order to make it an effective instrument the MTEF will have to be aligned with the 'political cycle' too. Another element may be the very cautious approach to disbursing against appropriations, in which basically the MoF disburses only 90%. If, towards the end of the year, revenue projections allow for it, the MoF has the discretionary power, without the need for asking Parliamentary approval beforehand, to allocate the available funds. This large discretionary power during budget execution may in effect work to reduce predictability in an environment where policies are determined at the margin. Similarly, this may discourage spending units to improve budget formulation and medium term budgeting.

For the coming years it is envisaged that the central challenge for the Ministry of Finance would be to improve capacity within the Ministry itself but particularly in the spending units to make them plan and budget for policies themselves. This will require a delicate mix between relaxing some of its own detailed authority in favour of the spending units to take up their new envisaged responsibilities, while maintaining control on public finances. This broad strategic direction is consistent with the very concrete challenges that are apparent in areas such as fiscal decentralization or the rollout of programme budgeting.

A particular area of reform is at a very practical level but relates to institutionalizing the coordination of activities both within the MoF and between the MoF and the spending units. This is one of the aims of the Medium Term Strategy of 1999 and has not yet received enough attention. In particular within the MoF the interviews made clear that this was one of the major areas where progress was needed in order to make internal operations more effective.

An area in which progress is slow and difficult is the Financial Management Information System. Preparations started already in 1998 but no complete rollout to spending agencies has yet taken place. As of today only one module of the SAP system is currently fully functioning. It is considered one of the ‘headaches’ in budgetary reform in Bulgaria and the system as well as the implementation process is currently subject of reflection in the MoF. A strategy on FMIS development is under development for some time but not yet approved. The general impression is that the choice for SAP as a system may have been misconceived. The system is regarded too complex, needs much more maintenance than was originally envisaged and a full implementation will consume much more resources than expected. Another issue that affects implementation is the difficulty to coordinate activities across ministries without a specific organizational structure that is backed at ministerial level. Similarly, it is difficult to convince spending agencies to start working with new systems as these are in effect an additional system which creates double work, because the old system cannot be discarded yet.

Similarly the capacity in the political process concerning the budget needs to be enhanced constantly to improve further the budget approval procedures by Parliament as well as to improve external control by Parliament through the judgment of the National Audit Office.



## 2 Bulgaria: process of budgetary reform

The question how budgetary reforms were implemented includes assessments of issues like the degree of ownership of the reforms, the leading agencies, possible laggards in the process or pockets of resistance to change. To what extent was the reform in Bulgaria a comprehensive or holistic one or was it conducted along specific lines? Were or are there any champions of reform, and were they used on purpose or was it by mere accident that they took on a role like that?

### 2.1 Planning of reforms

A question to start with is to what extent the process of budgetary reform in Bulgaria can be seen as one that developed more or less spontaneously or was to a more or lesser extent planned? After reading section 1.2 on Bulgaria's main budgetary reforms in the past decade the impression may be that a rather logical process has been followed starting with getting control on public finances, improving legislation and basic administrative procedures and regulations and slowly entering into more organizational changes and starting to look more forward including the medium term. Whereas this process may have evolved in a logical manner retrospectively it is another question to what extent this was foreseen and planned in such a way prospectively.

In fairness most probably quite a few changes were not planned in such a thoughtful manner. Whereas the re-establishment of the National Audit Office surely was definitely planned just as the development of the Organic Budget Law, the measures to deal with the crisis in 1996/1997 and its aftermath were clearly not spelled out beforehand. On the other hand the development of the Medium Term Strategy for the Ministry of Finance was a carefully developed document to which several reforms within the Ministry of Finance have been planned and organized even up to this date. The introduction of Performance Budgeting was also not carried out haphazardly but follows an explicit path of development in which after piloting a complete rollout is now in process. Similarly the fiscal decentralization process is following a well prepared plan of action.

In general considerable effort has gone into planning elements of the reform processes over the past decade. The time of the crisis and the immediate

aftermath were by nature a period that did not allow for planning during which quick and necessary decisions have to be taken swiftly. As one observer mentioned “the period of structured reforms started about 3 to 4 years ago.”

## 2.2 Role of main institutions involved in reform process

The National Audit Office was by its re-establishment in 1995 alone as a first mover in the process of budgetary reform. It has developed into a large organization, which is considered by many *policy* makers in Bulgaria a technically competent and modern institution. It has also considerable influence on Parliament. To call the NAO however a leader in budgetary reform is perhaps too strong, if it were just for the nature of its activities that do not easily attract attention.

The role of Parliament cannot be underestimated in the reform process, but it is not considered as leading or instigating reform. Typically, the day-to-day work of the Members of Parliament and their diverse background make a very technical topic like the budget and budget reform in particular not very popular. Nevertheless, the budgetary committee of Parliament has been busy to keep up with all the changes that were being implemented. The role of the Committee has been instrumental in disseminating knowledge about (new) procedures and reforms. Members of Parliament have also become more knowledgeable about the importance of the budget as a policy instrument and new regulations force the MPs to think ahead about future budgetary implications of the policies they want to instigate or approve. Parliament, in addition, has also not been a major stumbling block for the approval of reforms in recent years.

The leading agency in budgetary reforms is clearly the MoF. It has clearly owned the reform process in different stages over the past decade and under different political leadership. The interviews also showed that it is regarded as such by all other stakeholders and it should keep that role. Clearly the MoF is not en bloc a champion of reform. It is itself an important object of reform and departments and people have different views on how things should progress. The general view outside the MoF, however, is that at a technical level the MoF has always had a clear lead in the process of reform. Given its central position in the budget process and the large authority the MoF enjoys towards spending units it is also the only institution that could take up such a role. The future challenge of the MoF is perhaps that it should continue to lead and help spending units to take up their own responsibility simultaneously.

Two external organizations play (-ed) a very influential role in the budgetary reform process in Bulgaria. These are the International Monetary Fund and the European Union. The first one had a natural role to play in helping Bulgaria manage the crisis of 1996/1997 and was key in getting the CBA into

place to restore macroeconomic stability quickly. The IMF had a large influence on the Government not only through its formal role but also by having resident advisors in the MoF that were active and instrumental in developing the necessary changes to improve the comprehensiveness of the budget. The resident adviser within the MoF was also technically chairing the development of the Medium Term Strategy. In recent years the IMF has become less actively involved and the last resident advisor left the MoF in 2003.

The European Union and the European Commission have been and still are important for budgetary reforms for several reasons. The prospect of accession and earlier the hope to become invited for accession guided and fuelled decisions and directions for budget reform. Changes that are necessary for EU accession face perhaps a different political decision making process. EU accession has provided an overarching long term strategy for Bulgaria including for budgetary reforms. Secondly, accession to the EU asks for specific measures for the control of EU funds. The establishment of a National Fund within the Ministry of Finance is an important example of such a measure. The National Fund is a central treasury entity within the MoF that handles and disburses the EU's external assistance, which is a mandatory requirement. Also in the field of Audit, both internal and external, the EU *acquis* has specific regulations that have to be implemented by Bulgaria. Thirdly, the EU has been a major supporter of budgetary reforms through several capacity building projects in particular in the MoF. In effect, the EU financed the preparation and implementation of large parts of the Medium Term Strategy for the MoF.

The World Bank was not very active in public finance reform in the 1990s but became more involved recently through the support for fiscal decentralization. Another external partner in the preparation of reforms in this area has been USAID. Other bilateral partners supporting budgetary reforms have been the Netherlands through several projects in the field of Programme Budgeting and most recently its technical assistance towards the foundation of the Public Finance School. United Kingdom through DfID has been active in the adjacent but very important area of public administration reform including civil service reform.



# 3 Bulgaria: role of capacity building in budgetary reform

Capacity building here is viewed as the process by which individuals, organizations, institutions and societies develop abilities to perform functions, solve problems and set and achieve objectives. This definition is in line with the definition used by the UNDP to describe capacity building.

Capacity building is relevant in all phases of budget reform and relates to all phases of the budget cycle, be it budget preparation, budget execution, accounting reporting, or internal and external audit. Capacity building relates also to all parties involved in budgetary reforms. As such these statements are a general conclusion as well as a starting point for a discussion on the role of capacity building in budgetary reform.

## 3.1 Capacity building to improve external control

The National Audit Office has developed into a large organization since its re-establishment in 1995. Starting with 10 people and two computers, the NAO has seen a boost in its human resource capacity with a current staff of over 600 auditors. It is clear that the development of this organization is a capacity development in itself, because managerial structures had to be adapted regularly to cope with the growth and the decentralization of the organization with six regional offices. The NAO faced a favourable position because the growth in the staff capacity of the organization was facilitated with sufficient resources to accommodate them. At a technical level the NAO is very much focused on international experience and international standards to comply with. Focal point in this development to reach international standards has been the European Court and INTOSAI. Close working relations are being maintained with these organizations. Similarly, the NAO has (had) several twinning relationships with Supreme Audit Institutions of different EU countries in particular the United Kingdom and Germany which are considered very useful. The twinning relationships are particularly helpful when learning about new instruments for audit, when it is very valuable to have a hands-on and experienced based coaching relationship. The role of training of people has been extremely important. The NAO has developed its own system of Training-of-Trainers to cope with and economize on the large demands for training. Training includes technical and professional training as well training on skills.

As discussed above the role of Parliament has been constructive but merely following the developments that happened in budgetary reform. Members of Parliament have shown increasing attention for budgetary implications of policies and become more aware of the rules and procedures governing the budget. Although MPs have very diverse backgrounds it is left to the political parties themselves to organize technical and professional courses for them. Therefore, the progress made owes much to the day-to-day work of the Budgetary Committee and the advisors to the committee. An additional advisor has raised the capacity of the Committee in recent years. In the beginning of the 1990s the Budgetary Committee and advisors went frequently to other countries to inform themselves about modern budgetary practices made possible under several externally funded programmes. However, in recent years Parliament has not been explicitly involved in reform programmes on budgetary reform, except for invitations by the MoF to attend meetings or workshops that are deemed necessary for the advisors to the Committee.

### **3.2 Organizational changes in the Ministry of Finance**

The MoF as lead agency of the budget reforms is often the initial object of reforms and afterwards the main instigator to implement the reforms in other organizations. In Bulgaria it has large powers to decide on budgetary issues and budget allocations. It is for instance the sole presenter and defender of the full budget in Parliament and up to now has the discretionary power to decide on disbursements during budget execution without the need for prior approval of Parliament. The reforms in and by the MoF in the past decade have been very diverse and far reaching. Several important elements in terms of capacity building have become apparent during the interviews with policy makers inside and outside the MoF.

A very positive role is attributed to the resident advisors of the IMF that were present in the Ministry until recently. Not only did they serve as source of information and knowledge about technical issues on budgetary reform, but they also took a lead in advising the Ministry on how to develop the budgetary reforms. Another general service of the IMF that was mentioned several times in very favourable terms was the Joint Vienna Institute, an IMF trainings institute that is used frequently by staff of the MoF for professional training.

As part of the reform process the Ministry underwent several organizational changes in recent years. These changes had several specific aims amongst others to fulfil EU requirements for budget management and by making a distinction between medium term planning and budget preparation on the one hand and budget execution in terms of organizational structure on the other hand. In addition a Treasury department was created. As of today the experience of these organizational changes has been rather mixed in particular the organizational split between medium term planning, budget pre-

paration and budget execution. The organizational split further increased the need for close horizontal communication and coordination structures at all levels in the ministry. To a certain extent these structures have yet to become effective.

### **3.3 Human Resource Development in the Ministry of Finance**

A separate goal of the organizational restructuring of the MoF was to increase and professionalize the attention for human resources. In the past Human Resources was often considered more a unit for legal issues in personnel affairs. To signal the new status the existing Human Resources division was made a Directorate and allocated additional staff. The Directorate has been put in a position to significantly alter its previously administrative role and the perception of others as to the services it can provide and the value it can add to the Ministry as a whole. The increase in the number of staff has created further opportunity to augment existing administrative functions with the provision of more strategic and proactive services, for example in the areas of performance management, compensation and benefits & training and development. This increase in staff will also facilitate the creation of a more flexible and team oriented Directorate within which individual skills and competencies can be developed. In its new role the Directorate has focused initially on establishing and implementing procedures for selection and staff assessment, procedures that had not been there or were outdated before. New selection procedures included special attention on professional tests and interviews as well as language skills. The new HR Directorate also played an important role in defining new, modern job descriptions that were in line with the new functional characteristics that were developed for the restructuring of the ministry. The new job descriptions put more attention towards the non-content elements of the jobs in addition to an outline of main duties and responsibilities. Previously job descriptions had tended simply to provide a highly detailed and prescriptive list of tasks. In the last year the department also managed to start working with regular training programmes for staff and managers in the Ministry. The development of the HR division has benefited greatly from the new standards that were developed under the Civil Service Reform and received on-the-job coaching from both international and national advisors, short term as well as long term for a period of about two years.

For the future it is considered key to the successful development of the Human Resources function that a further commitment is demonstrated at the highest level to this intent. Equally important is the need to instil throughout management in the Ministry a real understanding of the scope of the HR activities and the contribution that can be made to the Ministry's success through the efficient provision of HR services.

To attract and keep professional staff a competitive remuneration is a prerequisite on the longer term. However, remuneration standards in the public service cannot compete with private sector conditions and civil service regulations do not allow for much flexibility in this area yet. Nevertheless, the Ministry of Finance has managed to create an ad hoc system through which it is able to make additional payments for those that perform well. In addition, the Ministry of Finance enjoys a relatively good reputation as a government employer and is able to attract and retain young people that are probably also sensitive to the good professional standing of the Ministry within the Bulgarian Government.

### **3.4 Establishment of the Public Finance School**

A major initiative in terms of capacity building has been the establishment of the Public Finance School (PFS) of the MoF. After several years of preparation the PFS was created in 2003 and had its formal opening in April 2004. It is considered an integral part of the overall reform process. The PFS was created as a practical tool directed to the needs of the administration, and instrumental to harmonization of budget principles and procedures in line with the EU requirements. At the same time the tendency towards decentralization of the budget process requires a major effort to build up capacity in spending units and municipalities.

The PFS is set-up as a specialized division in the Budget Directorate of the MoF and has a permanent staff of 6 professionals. The PFS works closely together with the other directorates in the MoF as well as with the line ministries, directly involved in the budget process. Relationships on technical cooperation with the international financial institutions have been established and the PFS acts as the national coordinator for the regional Centre for Finance Training in Slovenia.

The PFS puts a lot of effort into establishing the real training needs of different target groups and performs training needs analysis, develops training programmes and conducts training courses and seminars. It makes use of staff of the MoF under the leading principle of 'practitioners train practitioners'. In its short life span more than 500 employees of the public administration have already been trained and 22 courses and seminars conducted. The existing curriculum includes topics as diverse as:

- Medium term expenditure planning and programming;
- Methods and techniques for performance and programme budgeting;
- Financial Management Information System;
- Budgetary accounting and reporting;
- Financial Audit and Control;
- Management of EU projects and programmes;
- European Integration in the financial and budget area; and
- Didactical skills

Important courses that were recently conducted are amongst others “Budget reform – Bulgaria and international experience” and “Debt Management” – both organized by the World Bank with the support of the PFS and “Fiscal Decentralization” – organized together with USAID.

The establishment of the PFS is a major development in capacity building and its success was built up gradually. Using knowledge and experience from international experts, links were established with several institutions including the National Academy for Finance and Economy in the Netherlands and the Centre of Excellence on Public Finance in Slovenia. Much attention was also paid to sound operational principles through a separate Business Plan. General support for the concept of a Public Finance School was built by promoting it during various courses provided under ongoing external support programmes of the MoF. During these courses also the first potential trainers were identified. In addition, to these informal preparations, also explicit attention was asked from the Council of Ministers on the necessity and importance of the PFS. Having established the school as a functioning organization the school was completed once it received its own basic educational facilities. The PFS received financial and technical assistance in the set-up and development of the school and continues to receive assistance through a full time resident expert of the Netherlands Ministry of Finance.

### **3.5 The development of Programme Budgeting**

The immediate ‘partners’ in the reform process for the Ministry of Finance are the Line Ministries or first line spending units. In a sense they could be considered beneficiaries of the budgetary reform, as it should help them to improve and implement their policies. This perspective has not yet been much apparent in the reform process in Bulgaria, however. This is not to say that no efforts have been made in this respect, but the role and capacity of the line ministries has not yet fully been acknowledged in the process. Line Ministries still see the budget as a financial document that is prepared and governed by a MoF that bears ultimate responsibility. Accountants in those ministries manage the budget and no clear internal links are available between those financial departments and the policy makers of the Ministry.

This missing link between policy making and budgeting has become a serious capacity constraint in the development and implementation of the programme budgeting approach. Initially linking up with the finance departments of the line ministries it became evident that the inherent integrated decision making process in the line ministries was not existing. Therefore the MoF prepared a decision in 2003 to create financial and economic units in each spending unit but this has not yet been discussed in the Council of Ministers.

Linking the financial and strategic policy departments in the spending units will be a prerequisite for the successful rollout of the programme budgeting methodology in the coming years, however. So far the introduction of programme budgeting has followed a gradual pace. A start was made back in 2000 with an experiment to create a programme budget for the Ministry of Environment supported by external assistance. Based on this initial experience a decision was made to implement programme budgeting as a new budget methodology for the whole government. In the past years much time and effort has been spent on improving the methodology on formulation of objectives, programmes and consolidation and allocation of resources. In this process use was made of additional experiences in two more pilot ministries. Although the rollout of the methodology for budget preparation has received much attention, also through the training by the PFS, the current challenges are also to adapt the accounting and reporting to the new methodology.

It is illuminating that line ministries name the introduction of PB as the start of budgetary reform for them. So far they have only occasionally been involved in the process or in the externally financed projects supporting the reforms. Certain ministries, however, have taken up a more active position towards reforms such as the Ministry of Environment that was the 'guinea pig' on which the development of the PB was tested. Similarly, the Ministry of Energy and Natural Resources experimented with policies based on objectives and tried to structure its budget along these lines. In both cases the ministries enjoyed dynamic leaders that took a personal interest in improving the functioning of their organizations.

### **3.6 Instruments for capacity building**

Capacity building in the budgetary reform process in Bulgaria has been done using a multitude of instruments and approaches to improve structures, organizations, or individual capacities. It is not within the scope of this assessment to discuss all the modalities but certain interesting and important elements resulted from the interviews.

Human resources are key and training them is crucial. This concerns training of basic working skills (presentation, writing, etc.) as well as professional training on specific topics. An important issue here is also effect of knowing foreign languages, which helps, and quite often is crucial, to expose people to new knowledge and working practices.

Technical assistance has come in many forms in Bulgaria and whether it was effective was not only dependent upon the quality or effort of the persons providing the TA. Bulgarian policy makers have themselves become very aware that 'knowing what you want them to do' or "having a very clear terms of reference' is necessary to make the most of international consul-

tants. Another type of TA that is being used extensively is twinning arrangements with ministries or institutes of other European countries. According to one observer they have the important advantage of being able to tap from hands-on experience, which can be used in a more coaching like style of support. Sometimes, languages play a role under these twinning arrangements, because the experts are not always used to working in a foreign language. TA through consultants sometimes lacks this direct hands-on experience, but tends to be more flexible and may be based on a broader international experience, which helps to compare structures and linking different elements of reform. Consultants often take charge of managing parts of the reform process.

Another useful tool have been study visits. They do not only have the important advantage of serving as a possible incentive in the organization, but they are generally regarded as relatively efficient: “by seeing the actual situation and concentrating on the topic for a full week, I’ve learned much more than in several training courses on the same topic”.

Changing the culture of an organization is notoriously difficult and so are the experiences in the Ministry of Finance. An important element, implicit sometimes, is the shift to a more modern and performance oriented culture in budgeting but also in the organization. According to one observer Ministries of Finance are particularly disadvantaged for such a change. They tend to be rather conservative in culture and even cherish this as an effective and desirable cultural element. Cultural revolutions are not possible therefore and not even desirable, as they would probably lead to a sudden loss of well established norms and codes. The Bulgarian MoF tries to cope with this paradox by slowly but steadily hiring young staff to bring in new talents with fresh ideas, while maintaining a solid base of proven knowledge and experience.

The Bulgarian MoF does not maintain special relationships with other Finance Ministries in Eastern Europe to exchange experiences in budget reform. According to the MoF almost no active platforms seem to exist in which Eastern European policy makers inform each other about budgetary reforms in their countries. This is considered an opportunity, as their experiences are most likely to be very relevant for each other. Establishing these links may prove effective and worthwhile because they would short-circuit the exchange of ideas and practices on implementation through international consultants.



## 4 Bulgaria: conclusions and lessons learned

Capacity building has been of enormous significance for budget reforms in Bulgaria. In a sense, although this may sound commonplace, budgetary reform is capacity building. Capacity building is relevant in all phases of budget reform and relates to all phases of the budget cycle, be it budget preparation, budget execution, accounting and reporting, or internal and external audit. Capacity building relates also to all parties involved in budgetary reforms.

Reforms tend to have a logical structure when looked upon afterwards. Although Bulgaria has worked along plans for the reform in general the reality on the ground has shown that the reforms also were brought about by improvisation on the spot especially in the light of the crisis and its aftermath that Bulgaria experienced. This should serve also as a background for capacity building exercises that they cannot be planned as sometimes is desired.

Bulgaria has reached fiscal discipline through the exceptional measure of a Currency Board Arrangement, which still serves as strong safeguard. The immediate needs for reform lay in the field of resource allocation and operational efficiency. The CBA has been extremely useful and necessary to gain and maintain fiscal discipline. From the point of view of budgetary reform, however, this successful institutional arrangement may make the shift towards medium term budgeting and the introduction of a MTEF more difficult. The technical nature of the CBA has taken away the pressure for political arrangements that are supposed to replace the CBA eventually. Aligning the political cycle and the budget cycle will bring this link more clearly in the picture.

Bulgaria is busy improving the effective day-to-day *structural* working relationships within the MoF but to some extent also between the MoF and other parties. The lack of horizontal coordination structures has been noticed for some time. This seems an important area where cooperation among persons and institutions could be improved and one that seems difficult.

Parliament has not been actively involved in the reform process over the past decade. The knowledge of Members of Parliament will need to be upgraded further for them to take on their new responsibilities and procedures associated with medium term budgeting and the introduction of a MTEF.

Line ministries have not been actively involved in the Bulgarian reform process until the start of Programme Budgeting in 2002. Taking into account the independent role that is envisaged for them in the future, there is a strong need to start building capacity in those organizations. It may involve organizational changes as well as additional capacity that would enable these ministries to start linking their policies and budgetary decisions.

The newly established Public Finance School has become an important milestone in the process of capacity building so far. At the same time it is a valuable asset in the future process of capacity building in the government. Although demands and institutional settings will vary between countries it seems worthwhile to investigate the opportunities for the (concept) of a separate PFS for other countries in transition.

The role of accession to the EU cannot be underestimated in budgetary reforms. Providing an overarching goal for the country gives an umbrella to which budgetary reforms can be attached and which fuels a strong drive for change in the country.

## 5 Interviews Conducted in Bulgaria

Parliament	
Mr. N. Babamov	Advisor to Budgetary and Financial Affairs Committee
Ministry of Finance	
Mr. L. Datzov	Deputy Minister Budgetary Affairs
Mrs. B. Pencheva	Director, Directorate for Management of EU Funds
Mr. V. Petrov	Director, Directorate State Expenditures
Mr. B. Pindjurov	Director, Budget Directorate
Mrs. I. Paliova	Director, State Treasury Directorate
Mrs. T. Georgieva	Director, Human Resources Directorate
Mrs. A. Mihailova	Head of the Budget Policy Division, Budget Directorate
Mrs. Rossitza Velkova	Head of Division “Sustainable economic development”, State Expenditures Directorate
Mr. Tz. Mikov	Head of Budget Methodology Division, Budget Directorate
Mr. Tz. Petrov	Head of “State activities” Division, Directorate Municipal Finances
Mrs. G. Tzekova	Chief expert Public Finance School Division, Budget Directorate
Mrs. M. Saraivanova	Junior expert Public Finance School Division, Budget Directorate
Mr. I. Kostov	Junior Expert, Microeconomic Analyses Division, Budget Directorate
Mr. R. Brinks	Project Manager – MATRA MATo3/BG/9/2 “Establishment of PFS”
National Audit Office	
Mrs. N. Sandolova	Member of The National Audit Office
K. Krasteva-Kaleva	Member of The National Audit Office
World Bank	
Mrs. S. Ilieva	Economist

Ministry of Education and Science

Mr. D. Tanev                      General Secretary

Mrs. S. Krastanova              Director, Directorate Finance

Mr. S. Kanev                      Director, Directorate Politics in Higher  
Education

Mrs. P. Ganova                    Head of Department Vocational Education

Ministry of Energy & Energy Resources

Mrs. I. Chinkova                  Director, Directorate Finance, accounting and  
property management

# List of abbreviations and acronyms

CEECs	Central and Eastern European Countries
COFOG	United Nations Classification of the Functions of Government
ECB	European Central Bank
EMU	European Monetary Union
ESA	European Standard Accounts
EU	European Union
IMF	International Monetary Fund
MTEF	Medium term Expenditure Framework
NIS	Newly Independent States
OECD	Organization for Economic Cooperation and Development
RFSP	Pre-accession Fiscal Surveillance Procedure
TSA	Treasury Single Account
UNDP	United Nations Development Programme



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