PUBLIC EXPENDITURE MANAGEMENT

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1. The overall strategy of reform

In recent years, the federal budget process as a mechanism for setting resource priorities, and controlling the use of those resources to attain policy objectives, has been steadily undermined. The continual failure to face decisions on what should be the core role of government—to identify what constitutes government services and what does not—has meant that no explicit policy decisions have been taken on nonessential services to be scaled back or eliminated. Without such a fundamental review of the structure of government operations, unrealistic budgeting has been the rule. Insufficient revenues to meet all budget needs has resulted in continuous forced expenditure sequestration, lack of efficient controls over budgetary commitments, forcing fiscal adjustment from the federal to lower levels of government, and creating a large gray sector within government, which largely goes unrecorded and escapes regular budgetary controls.

The excess of budget commitments over available resources has undermined the meaningfulness of budget numbers, by giving rise to a variety of ad hoc mechanisms that have been employed in the last decade:

- *Payments in kind* have persisted, being transacted at nonmarket clearing prices they represent a hidden subsidy to nonviable enterprises and perpetuate soft budget constraints.
- *Tax expenditures* are not *reported*, but are pervasive.
- *Significant indirect subsidies* to large enterprises have constituted a directed flow of resources that are not reflected in the budget (so-called "quasi-fiscal operations")
- *Tax offset*s have represented a substantial loss for budget recipients and implicit subsidy to providers, owing to higher prices and discount on tax payments. Moreover, expectations of future offsets have undermined tax discipline and encouraged new tax arrears.
- *Expenditure arrears* have been endemic in key sectors, such as energy and military procurement where bills are settled in kind or noncash means, and have aggravated other problems—as a consequence, for example, energy companies have failed to pay taxes and have courted tax offsets or indirect subsidies as compensation.

*The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy.

All of these ad hoc solutions not only have reduced the transparency of the budget process, but have led to major inefficiencies in resource allocation, and have compounded the difficulty in redressing the fundamental problems of fiscal management. Moreover, they have provided a profitable business for intermediaries (discounting and floating associated financial flows) and a huge source of rent seeking. Owing to this, large vested interests have arisen to defend these practices and now may represent an important barrier to reform.

The overall strategy from a PEM perspective is twofold:

- **to eliminate this gray noncash government sector by covering these transactions in the budget process**

- **to improve the budget process by introducing more transparent, internationally accepted standards, both in budget preparation and execution, for all government operations**

The aim of these reforms should be to provide the information base to undertake a fundamental review of the role of government in the Russian Federation and obtain a more realistic appreciation of the size of core government activities that can be financed from the present tax base. Addressing these issues requires a high degree of political commitment and a concentrated effort by the central agencies of government, but this most fundamental structural issue lies more in the domain of expenditure policy rather than expenditure management.

2. Eliminating the "gray" government sector

- **Resolve the arrears problem**

Arrears have arisen from a number of sources: fiscal indiscipline in powerful ministries, entering into commitments that exceed their approved budget allocations; commitments made within budget allocations but below commitment levels set by the Budget Policy Department; and commitments made within Budget Policy Department limits but without treasury cash backing. The approach to stopping the creation of new arrears, must be multidimensional:

- arrears arising from the first two sources may at least partly be addressed by **more realistic budgeting** (see below)

- arrears arising from failure to provide sufficient resources to meet commitments made can be addressed by **better financial planning** (see below)

However, whatever the solution there is the need to set up **a system for monitoring and then controlling the expenditure commitments** that are being made. Practically, this would be introduced in stages.

Strategy:

Stage one: commitment recording

By order no. N-806 dated July 15, 1999, a system for recording all commitments at the treasury was introduced for spending codes: 110721, for "heating and technological necessities;" 110722, "consumption of natural gas;" 110723 "consumption of fuel for boilers;" 110730 "electric power;" and 110740 "water supplies to premises and facilities." This should be extended to other relevant expenditure categories, to cover most areas were contracts must be signed for delivery and the FT should provide monthly reports on commitments undertaken.

Stage two: move from registering to control

Payment orders will only be processed in the FT against legitimately registered commitments, and only up to the levels implied in those commitments. Three issues must be resolved before commitment control can be truly effective. First, there should be a clear demarcation between SUs that are legitimately inside government and those that are enterprises, outside the budget. Second, the Civil Code may need to be amended to define and limit the rights of government SUs to enter into contracts with suppliers. Third, the FT in registering the commitment, will issue a "visa" recognizing the liability, and in effect guaranteeing payment when the liability comes due. Since the system will break down if the visa is not honored, it is therefore essential that concurrently the FT develop its capacity:

- *for tracking arrears*

Once commitments are recorded, the information would be gathered into a system to track arrears and make the necessary inputs into the budget execution process. Given the scale of the country and the number of SUs, this will require further computerization, major progress being made on the interim system, and a reliable register of SUs. The software for this would be required to be developed and the basic system of recording would need to be stabilized and tested before stage two is launched.

- *for cash management*

The tracking of commitments would be an essential input for cash management. This means that rather than the present backward-looking reactive cash management the FT would have to engage in forward looking proactive cash management—better forecasting future revenues and future expenditures coming due. This will involve the FT taking over the partial revenue forecasting functions of the Budget Policy Department and assuming a more central role in the determination of commitment limits. The aim would be to establish a system of rolling three monthly cash flow forecasts, to guide the commitment limits of SUs and to adjust borrowing in line with cash flow requirements. As a first step, the coordination between the

FT and the Budget Policy Department should be improved in determining the information base for setting these limits.

- **Eliminate off-budget activities of budget institutions**

The off-budget activities of budget institutions have expanded as pressures on their regular budgets have increased. So substantial and important are these activities that it is difficult to separate them from their statutory role, thus generating great possibilities for cross-subsidization and misuse of public funds. Although this problem appears to be larger, and growing, at the lower levels of government, an attempt should first be made to integrate these activities into the budget at the federal level.

Resolution N 1001 of August 22, 1998, and Executive Order 39-N of 10.6.99 prescribed a form 4-DVs to consolidate and register in the FT all off-budget funds. To-date lists of such off-budget funds have been obtained from the CBR. The FT is in the process of issuing permits to line ministries (and SUs through them) for opening such accounts and the work is near completion. However, the CBR does not recognize the right of the FT to obtain details of these funds since as legal entities SUs have the right to bank accounts and can avail themselves of bank-client confidentiality. It is important this legal constraint be removed.

Strategy:

- *Stage one:* reports on inflows/outflows and balances in these accounts (this should be feasible either by a change in the law allowing direct CBR reporting, or by developing a reliable system of reporting from the SUs)

- *Stage two*: estimates of these flows shown in budget documents for information only, and all legal barriers removed.

- *Stage three*: all bank accounts for off-budget activities closed and transferred to FT ledger accounts, so payments transacted through the treasury system.

- *Stage four*: a review of off-budget operations, to decide which should be on and which off budget (e.g. enterprise functions); for the former, regular estimates reduced in light of off-budget activity

- *Stage five*: consolidation of regular and off-budget estimates.

Apart from ruble accounts there are also multiple bank accounts for *foreign currency balances of the SMs, tax authorities and SUs*. This practice developed as a result of volatility in the exchange rate of the ruble, prevents the consolidation of government cash resources in one account and limits the FT's capacity for cash management. The strategy should be to progressively close these accounts as soon as feasible. All foreign currency earnings of government agencies should be transferred to the TSA and all foreign currency requirements should be purchased from the CBR, at the prevailing exchange rate.

- **Increased coverage of the treasury system in budget execution**

Power ministries

The Russian defense establishment operates as an enclave that is very independent of the rest of the budget, and normal budgetary practice. This is manifested in many ways:

- separate budget classification
- treatment of social security payments on salaries are covered separately under federal budget on behalf of the MOD
- a large number of social SUs exist under the defense umbrella, paralleling/overlapping with other parts of the budget
- a large number of military-related agencies have become semi-autonomous or "civilian" and placed off-budget, e.g., Federal Defense Road Building Directorate

It is important to increase transparency in this area by the inclusion of MOD operations into the FT system. The MOD and the Treasury have two pilot projects in the Privolzhski Military (Samara) region and the Baltic Fleet for the FT's processing of payment orders. The lessons learned from these pilots have indicated the large number of transactions which could result from the inclusion of the MOD in the treasury system, possibly over-extending the FT's present processing capacity in attempting to meet the this requirement by the mid-2000 target date.

Strategy

Stage one: Develop and test a software/hardware solution to increase capacity to include the SUs of the MOD, and eliminate the overlap of MOF and CBR functions in this area.

Stage two: Develop a transition plan to absorb the "social" nonmilitary SUs first, and then progressively all other units. This process of absorption should run parallel with a general rationalization and reduction in the total number of SUs. A date should be set for the beginning and end of this phased approach.

Customs Commission Accounts

On the revenue side of budget execution, these accounts are the largest exception to FT's coverage. Part of this problem appears a technical one of developing software to handle the accounts.

Extrabudgetary Funds

There are five major funds at the federal level: Pension Fund, Social Insurance Fund, Fund for Obligatory Medical Insurance, Federal Employment Fund, and Federal Road Fund. They play a major role in the economy—accounting for a combined 9.4 percent if GDP in 1997 the first four financed through payroll taxes—around 38 percent of the wage bill. A major tax burden combined with poor service delivery indicates this is a priority area for reform. It is assumed that the first three will be restructured and reformed but in this process will remain as separate entities for the foreseeable future.

Strategy:

Stage one: Road Fund

This was expected to be brought under treasury execution by FY 2000, but was not. Since this Fund presently uses the budget classification, no technical problems should be encountered although the FT's capacity may have to be extended to handle the extra workload.

Stage two: Employment Fund

This fund uses its own classification system, and it will be difficult to change this over to a budget classification since there has been no software developed to link the two classification systems. Realistically this conversion will take some time to implement, and this may provide the authorities the opportunity to review the operation of this Fund and decide whether to retain it in its present form or transform it into a social assistance program fully integrated in the budget.

3. Increasing transparency in budget operations

The authorities have recently completed a questionnaire on fiscal transparency, the answers from which provide a good basis on which to improve fiscal transparency, identifying a number of areas that provide a nucleus for comprehensive structural reform of the budget process.

- **Measures to improve transparency in budget preparation**

Many of the problems in preparing a realistic budget arise from the deficiencies of the prior stage within the budget cycle at which strategic options for the budget are clearly defined and reviewed, and binding decisions are made on overall budget strategy. Several factors contribute to the ineffectiveness of this stage:

- lack of clarity in the respective roles of executive and legislature in budget formulation. The Budget Code makes provision for fundamental remaking of the budget by the legislature, yet the latter lacks either the technical support or the necessary time within the budget cycle to undertake this role.

- the process of budget formulation is relatively centralized, with central agencies playing a relatively direct role in determination of allocations, including the use of centrally fixed expenditure norms.

- the substantial deviations between budgeted and actual expenditure levels gives little incentive for budget agencies to invest time and effort in realistic costing of policy options and preparing budget projections.

- At no stage in the process is there a transparent statement of budget strategy, linking proposed policies, objectives and broad budget allocations in a comprehensive manner (preferably more than a year ahead), which would facilitate clear decisions on what can and cannot be financed.

Again, these factors reflect the failure to review the strategic role of government, and the fundamental problem of the lack of clear expenditure policies underlying budget allocations. As a result, the present basis for budget estimates is not transparent, and does not ensure the connection between budget authorization and the real obligations of the government. A better definition of the expenditure estimates is required, for instance, by the Budget Policy Department fully including registered commitments when formulating budgets. Another factor which has given rise to unrealistic budget estimates is Article 238 of the Budget Code that states that budget institutions have a right to receive any unfulfilled budget provisions, making no allowance for the level of resources available. This article should be reviewed. Transparency is further obscured by the budget being prepared and approved on a functional basis and largely executed on an agency or SU basis. This has contributed to the fact that most of the information produced by the budget process is late, incomplete and analytically meaningless.

Strategy:

Stage one: In budget preparation it is recommended that standards for revenue and expenditure estimates in the budget be developed on the basis of a study of international practices and that these be promulgated, say, prior to the completion of the FY 2001 Budget. These standards would be based on a clear definition of existing policy expenditure commitments and a methodology to ensure ongoing costs of government services are fully costed and realistically related to the macroeconomic framework. For this purpose a manual on modern costing methods should be developed and employed.

Stage two: Political approval of the budget should be improved by:

- modifying Article 238 of the Budget Code

- reducing the number of main budget units and SUs to encourage internal priority setting
- presenting the budget for approval on a Ministry/SU and program basis rather than the functional/SM basis at present
- on the same basis developing a system of monthly and quarterly reports aimed at performance review and supporting analysis of current year's budget
- presenting estimates of tax expenditures with the budget document

- **Government employment** is one area which lacks a coherent strategy that undermines sound budgeting

The government has acknowledged the need for reducing employment levels and improving public employee compensation, however, there is no real definitive data on the government's payroll. In addition, the wage bill is distorted by provision of a wide range of benefits in-kind—free apartments, medical clinic privileges, personal cars, subsidized meals, spa and resort services, etc.

Although these practices raise important issues of transparency, there appears little interest in the MOF in taking initiatives in this area. As a result of the unreliable banking network virtually all government employees are paid in cash on the basis of information submitted by a decentralized payroll unit in the line ministry. This essentially manual system is inefficient, and vulnerable to fraud, and does not provide information to the MOF. Payment of salaries and wages constitutes over 23 percent of the government's noninterest expenditure in the 2000 Budget. If the payroll is not computerized, control over such a large component of government expenditure will remain ineffective.

Strategy:

- Develop a standardized software package for payroll preparation, using the Social Fund Number as common identifier for payroll purposes.

- Develop a standards manual on payroll preparation for all budget institutions

- **Improve the accounting and classification of government operations**

The approved Chart of Accounts (COA) presently in use does not fully reflect the budget classification and makes provision for budget revenues and expenditures to be recorded in aggregate, while devoting disproportionate attention to the detailed analysis of borrowing (which does not follow budget lines). The structure of the COA seems to imply that accounting and fiscal reporting are two independent functions and are not inter-related. This approach perpetuates the present practice of obtaining budget execution reports in required detail from secondary sources, and not from the Treasury General Ledger (TGL). If budget execution reports do not originate from the TGL, since they cannot be independently verified, their completeness or accuracy is suspect. The basis of accounting used in the current COA also lacks consistency, with confusion between flows and stocks, and mixing a general cash basis approach with an accrual basis for selected items.

The present budget classification also needs further improvement. While adopting the functional and economic classification principles of the GFS system, it contains a number of modifications (e.g., including "financial aid to other levels of budgets" as a function rather than economic category). There are also problems with the coding structure adopted for the budget classification—a 19 digit code is too lengthy to be operator friendly.

Strategy:

- design and adopt a more internationally accepted COA as a basis for TGL computerization in the FT interim system
- clean up the classification system to eliminate conceptual confusion, assisting the generation of appropriate fiscal report formats.
- Streamline and standardize the classification codes.

- **Complete the development of the treasury system**

Apart from the establishment of a network of regional and local FT offices, the three other pillars of a fully operational treasury system are only partially established: a general ledger accounting system (GLS), a treasury single account (TSA), which consolidates government cash resources, and a system of integrated financial management which minimizes the cost of government financing and guides the speed of budget execution.

A major step in the development of the treasury system was taken with the approval of a Federal Treasury Development Program by government resolution (N.677) of June 23, 1999. The objectives of this program are to:

- implement a treasury single account in the CBR
- centralize all government operations in the FT accounts
- ensure implementation of a uniform accounting and reporting system based on a single accounting and budget classification
- develop, implement and facilitate an integrated treasury computer/communication system interfaced with the CBR settlement network.

As indicated above, there are major weaknesses in centralizing operations in FT accounts (e.g., off-budget accounts of budget institutions, customs accounts, the power ministries); and while the TSA has been advanced by a joint concept paper released with government resolution (N.107) or January 23, 2000, there has as yet been little centralization of bank accounts by the treasury offices at the regional level. Until this is accomplished the present delays in reporting daily cash balances and weaknesses in government cash management by the FT will persist. Accordingly, the overall capacity development of the FT should be encouraged, and to this end the authorities have developed a two-track strategy: an interim computer solution to integrate the diverse systems presently in use and to address the immediate functional requirements of the FT; and a longer term Treasury System Modernization Project, with World Bank loan funding. In the interim system it will be important to establish the fundamentals of FT operations which will focus on three main elements touched on previously:

- *complete the development of a GLS* (operated by the FT and integrated the accounting carried out in SUs) that will record all stages of expenditure, from appropriation, commitment, verification, and payment. Implementation will depend on computerization of FT and development of the interim system.
- *create a full TSA.* Complete the coverage of the treasury system, by inclusion of all power ministries, and the off-budget activities of budget institutions, closing the associated accounts and transferring them to ledger accounts in the treasury.
- *develop a system of reports, to support a financial planning capacity* that will construct rolling three monthly cash flow forecasts, to guide the commitment limits of SUs and to adjust borrowing in line with cash flow requirements (see above)

- **Strengthen the external audit function**

To support a reform program in public expenditure management it is essential to establish external checks on budget performance. In this regard the external audit function is critical. International experience suggests that this function is most effective when the supreme audit institution: has genuine independence from the executive, with timely access to comprehensive budget execution data; reports to the legislature, but is able to pursue a systematic, independently determined program of audit, with separate budgetary provision for any ad hoc investigations required by the legislature; and, confines its role principally to ex post audit, without compromise from any parallel engagement in the activities of budget formulation and execution.

In Russia, the Chamber of Accounts has been hindered in carrying out this role due to three main factors: inadequate expenditure reporting and accounts preparation by the executive; diversion from a systematic work program by the intervention of ad hoc investigations requested by the legislature; and, dilution of its core responsibilities for ex post audit by other tasks such as advice on budget formulation, intervention in budget execution and an enforcement role with respect to implementation of audit findings and penalties.

Strategy:

- improved timeliness and comprehensiveness in reporting budget execution by the executive (dependent on reforms in coverage and operation of the FT described above)
- legislative amendment to clarify the role of the Chamber, defining its responsibilities principly in terms of ex post audit
- with this refocused mandate, technically reinforce the Camber of Audit with more suitably qualified personnel, computerization, and a training program.

- **Continued commitment to meeting the IMF Code on Fiscal Transparency**

Clearly, the Russian authorities have taken significant steps in recent years toward establishing a transparent fiscal management system, and the new Budget Code which came into effect in FY 2000 provides the overall legal framework in which to further develop such a system. However, the Budget Code is far from perfect, and the FT has suggested a number of amendments to the Code, which should be taken up at the earliest opportunity to strengthen the legal framework for budget and treasury operations.

Many of the measures outlined above, directed at extending the federal treasury system and providing comprehensive, reliable and timely coverage of budget (and extrabudgetary) activity, will also be central in meeting the IMF's Code of Good Practices on Fiscal Transparency. Similarly, measures to refocus and strengthen the technical capacity of the Accounting Chamber will allow Russia to be better able to meet the Code's standards with regard to independent assurances of integrity of government accounts.

However, in addition there are some fundamental areas, which should be signaled here as requiring further work. For example, many key relationships between government and other sectors of the economy, particularly the banking and enterprise sectors, and between federal and regional levels of government need to be much more clearly defined by:

- Including a comprehensive report on contingent liabilities in the budget and government accounts
- Including a statement of fiscal risk, both those arising from contingent liabilities as well as changes in macroeconomic parameters
- Initiating a review of quasi-fiscal activity by selected key public financial and nonfinancial enterprises.
- Clearly defining general government as a central basis of fiscal policy would provide a focus for establishing an appropriate distribution of fiscal responsibilities for the federal government and the regions.